



State of California

2004 Voluntary Compliance Initiative



For Abusive Tax Shelters

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Executive Summary

Inappropriate tax sheltering activity has always existed as a compliance problem for tax administrators. However, in recent years such activities have escalated in size, scope, and sophistication, causing heightened concerns regarding the revenue impacts to state and federal treasuries. This report covers the background of the state tax shelter problem, the results of California's tax shelter amnesty program, and California's strategy to address tax shelters.

In 2004, the State of California offered its first amnesty program aimed at abusive tax shelters. Senate Bill 614 (Statutes 2003, Chapter 656) authorized the Franchise Tax Board (FTB) to administer the Voluntary Compliance Initiative (VCI), which allowed taxpayers that engaged in potentially abusive tax avoidance transactions to correct their state income tax returns. In exchange for full payment of additional tax and interest, participants avoided criminal prosecution and substantial new penalties.

- ◆ The VCI ran from January 1 to April 15, 2004. The final results were 1,202 taxpayers reported \$1.4 billion in additional tax liabilities by filing 2,289 amended returns for tax years 1990 through 2002. Program expenses totaled \$886,000.
- ◆ The majority of the VCI taxpayers were individuals and accounted for 67% percent of VCI participants and 65% percent of total VCI revenues. Corporations, banks, and pass through entities were the remaining participants.
- ◆ Approximately 175 taxpayers audited for tax shelter issues participated in the VCI. They accounted for \$531 million in VCI revenues.

California's strategy to address the tax shelter problem contains three components: compliance, detection, and enforcement. FTB worked closely with the Internal Revenue Service and other state tax agencies in all of these components. This report covers California's activities before, during and after the VCI as of its June 30, 2004 fiscal year end.

Background

Size of the Problem

The FTB administers the Personal Income Tax and the Corporation Tax programs that account for a majority (\$44.7 billion, or 59%, in fiscal year 2003/2004) of California's General Fund revenues. These tax programs rely on taxpayers voluntarily assessing the correct amount of taxes so California can fund state programs such as education, transportation, and public hospitals. However, individuals and businesses increasingly use sophisticated transactions to avoid or evade income tax. This trend poses a serious threat to the efficacy of the tax system because of the loss of revenue and integrity in the voluntary compliance system. Although it is difficult to estimate the fiscal impact of abusive tax shelters on the tax system, the following estimates illustrate the size of the problem:

- Federal government lost about \$85 billion over the last decade¹,
- States lost \$10 to \$17 billion due to corporate income shelters in 2001.²
- California lost \$2.4 to \$4 billion between 1999 and 2003.

Today's Generation of Tax Shelters

The tax shelter schemes that proliferated in the 1980's were relatively simple and straightforward transactions. Promoters promised deductions and credits in over-inflated amounts to tens of thousands of investors sheltering relatively small amounts per person. The current generations of tax shelters are complex technical transactions often coupled with aggressive interpretations of state and federal income tax laws. Tax professionals devised these tax shelters to bury their complexities in multiple layers of entities to escape detection. They packaged them as generic tax products with boilerplate legal opinions for mass marketing, sold them to thousands of taxpayers to generate millions of dollars in fees, and reduced by hundreds of millions of dollars the amounts their clients paid in state and federal taxes³.

The IRS provides public guidance on transactions deemed abusive with a designation known as a "listed transaction". In 1998, there were 5 listed transactions. By 2004, there were 30. Taxpayers and tax professionals ignored the IRS' guidance of unacceptable tax positions, and continued marketing abusive tax shelters at a disturbing rate. For example:

- In December 1999, the IRS issued Notice 99-59 to curtail the Bond and Option Sales Strategies (BOSS). A major accounting firm designed and marketed BOSS to shelter gains through a complex series of sale, loan and dividend arrangements.
- By August 2000, the IRS issued Notice 2000-44 to crack down on variations of BOSS (Son of BOSS) designed to escape provisions of the 1999 IRS Notice. Other accounting

¹ U.S. General Accounting Office Report 04-104T "Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters", October 21, 2003.

² Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections, Multistate Tax Commission, July 15, 2003. Estimate updated during June 2004, MTC States Compliance Initiative, Bruce Johnson, Chair of MTC.

³ "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals", Report prepared by the Minority Staff of the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs (U.S. Senate) dated November 18 & 20, 2003.

or legal firms marketed these BOSS variations and used short sales, digital options, and loan premiums to shelter gains.

- Although the IRS issued new regulations to deter such abuses in 2001 and 2003, promoters continued to design new strategies to escape application of the IRS notices and regulations and more variations of BOSS were born (using different financial instruments to create artificial tax losses, such as market linked deposits).

California State Controller Steve Westly stated, “The transactions we are seeing are so complicated that a typical taxpayer wouldn’t dream them up. Financial experts are going to great lengths to devise complex deals and push them on taxpayers through their partners and even through seminars.”⁴ The IRS estimates that just one of the listed transactions artificially reduced about \$6 billion in taxes for several thousand taxpayers.⁵

California Takes Action

Taxpayers will continue to engage in tax avoidance transactions and tax professionals will continue to market them as long as the risks are not significant. Previously, California had little effect on deterring investments or promotions of abusive tax transactions since the risk of being caught was low and the penalty regime was insignificant compared to the tax reductions realized by investors. These lost tax revenues had a detrimental effect on California’s budget situation since income tax revenues are a large part of California’s general fund account. By the end of 2002, California's audit inventory of tax shelter cases rose exponentially. It was apparent California needed stronger measures to reduce the escalating number of tax shelters.

As California considered legislative solutions, United States Senator Charles Grassley introduced legislation⁶ proposing tools to combat abusive tax shelters. Grassley's proposal served as a blueprint for California's legislation. However, California needed to act fast since the shelter activity occurred predominantly in 1999 and 2000, when the California economic capital gain income rose from \$93 billion in 1998 to \$164 billion, and \$200 billion respectively. Many high-income taxpayers sought to reduce their income taxes through shelters during these years. With the state statute of limitations quickly closing for the tax years with the highest levels of abuse, California could not wait for federal legislation and, on October 2, 2003, California enacted its pioneering tax shelter legislation⁷. The new law increased the risks and costs of using and promoting tax shelters, increased California's detection and enforcement tools and authorized a tax shelter amnesty program. The provisions jump-started California's detection and enforcement strategies while the administration of the VCI augmented self-compliance with minimal use of state resources.

The next section discusses the results of California’s VCI.

⁴ Statement by State Controller Westly in Press Release dated November 18, 2003.

⁵ “IRS Offers Settlement for Son of Boss Tax Shelter” IR-2004-64, May 5, 2004.

⁶ S.476, the CARE (Charity Aid, Recovery, and Empowerment) Act of 2003 108th Congress, first session) introduced on February 27, 2003 by Senator Charles E. Grassley (R-IA). See Title VII Revenue Provisions. Subtitle A Provisions Designed to Curtail Tax Shelters.

⁷ Senate Bill 614 (Statutes 2003, Chapter 656) authored by Senators Cedillo and Burton and Assembly Bill 1601 (Statutes 2003, Chapter 654) authored by Assembly Member Frommer). Both bills contain identical provisions.

Voluntary Compliance Initiative Results

The goal of the VCI was to promote self-compliance and accelerate revenue. The VCI allowed taxpayers who used an abusive tax avoidance transaction to correct their state income tax returns in exchange for avoiding criminal prosecution, lengthy litigation, and substantial penalties. The FTB conducted the VCI between January 1, 2004 and April 15, 2004.

Analysis of Revenue Received

During the VCI, 1,202 taxpayers reported \$1.4 billion in additional tax and interest from potentially abusive tax shelters. Individuals (804) and trusts (56) reported \$973 million (68%) in Personal Income Tax revenues. Corporations, banks, and pass through entities reported \$465 million (32%) in Corporation Tax revenues.

Table 1: Individuals are Majority of VCI Taxpayers and Revenues

Tax Program	Number of Taxpayers	Amounts (in millions)
Personal income tax	860	\$973
Corporate income tax	342	\$465
TOTAL	1,202	\$1,439

The three most notable outcomes were:

- Total revenues exceed a billion dollars.
- 90% of revenues are currently undisputed.
- 40% of VCI taxpayers waived their rights to appeal VCI amounts.

Total revenues exceed expectations

The billion dollars of self-assessed tax reported in the VCI exceeded expectations. Original estimates of potential VCI revenue were \$90 million. FTB audit staff noticed that relatively few taxpayers were involved in the tax shelter audit cases, but the amount of taxes they underreported were large- often close to a million dollars. While it was not clear how many taxpayers would eventually participate in the VCI, the number of taxpayers was not the key factor in any potential success of the initiative. The key factor to its success and the greatest impact to compliance was the average underpaid tax liability per taxpayer. Although some taxpayers reported overpayments, and some reported additional tax liabilities of tens of millions of dollars, the average VCI underpaid tax liability reported per taxpayer was slightly more than \$1 million. The \$1.4 billion in additional taxes resulted from taxpayers reporting an increase of approximately \$14 billion in California taxable income.

Many taxpayers seek to avoid consequences

California considered different components to spur the highest probability of VCI participation. During its cooperative efforts with tax professionals, California learned that relieving penalties would not suffice to entice taxpayers into compliance when investors and promoters believed detection was unlikely and penalties were inconsequential. To address this concern, California combined the VCI with the highest tax shelter penalties in the nation, applied some of them retroactively, and increased its cooperative enforcement efforts nationally. While raising the

stakes of not participating in the VCI, California also minimized taxpayers' participation risks by providing different options and, in some cases, allowing them to retain the right to dispute any tax agency findings.

Taxpayers had two choices when they participated:

- Avoid all penalties and waive their right to dispute the tax shelter amount (referred to as Option 1), or
- Maintain their right to dispute the tax shelter amount, and remain subject to one penalty (referred to as Option 2).

Table 2: VCI Allows Taxpayers Options to Participate

Is the VCI Taxpayer	VCI OPTION 1	VCI OPTION 2
Subject to New Increased Tax Shelter Penalties?	No	No
Subject to Accuracy Related Penalty?	No	Yes
Able to Appeal?	No	Yes

FTB's historical experience is that taxpayers do not voluntarily change their positions unless they can dispute the result. However, a significant percentage of VCI taxpayers (40%) chose to forego all appeal rights (Option 1) and reported \$355 million in VCI revenues.

Table 3: 40% of VCI Taxpayers Avoid All Penalties

Tax Program	Taxpayers electing Option 1	Taxpayers electing Option 2
Personal income tax	321	539
Corporate income tax	161	181
TOTAL	482	720

Small numbers of taxpayers dispute their VCI amounts

While 720 VCI taxpayers chose Option 2 (\$1.08 billion of VCI revenues) and kept their right to dispute the amounts reported in the VCI, only 36 taxpayers filed claims for refunds totaling \$42 million. As with any other self-assessed return, the remaining Option 2 taxpayers may file claims for refunds within the normal state statute of limitations⁸.

Other notable findings

VCI was applicable for all tax years before tax year 2003. The majority (77%) of the VCI revenues (\$1.1 billion) were attributable to tax years 1999 through 2001. This indicates the majority of VCI revenues came from the tax years with the largest amounts of capital gains. However, a surprising \$148 million (10%) was for tax years normally closed by the statute of limitations (tax years preceding 1999). Some taxpayers may have amended older tax years if

⁸ California Revenue and Taxation Code Section 19306; one year from overpayment, or 4 years from the due date of the original return, or date filed, whichever is later. See CR&TC Section 19311 for filing refunds based on federal changes.

Over \$300 million in VCI revenues came from taxpayers in states other than California. This reinforces government findings that taxpayers across the country are engaged in abusive tax shelters. Graph 1 shows the distribution of California VCI revenues received from around the nation, with amounts greater than \$1 million noted on the map. [Appendix B.7.6](#) provides further detail of amounts reported by states.



At the beginning of the VCI, California had over 400 audits opened or pending with tax shelter issues. About 150 of the taxpayers under audit participated in the VCI and reported almost \$500 million owed. About 25 additional taxpayers protesting or appealing their tax shelter assessments also participated in the VCI. They voluntarily reported \$31 million owed and had \$5 million in accuracy-related penalties waived to close their cases. Overall, the VCI accelerated the resolution of 175 cases for \$531 million.

Taxpayers who chose Option 2 remain subject to the accuracy-related penalty when FTB disallows any refunds for amounts paid in the VCI. In addition, any proposed deficiency

assessments to VCI taxpayers for tax shelter amounts not reported in the VCI are subject to two of the new tax shelter penalties:

- (1) Noneconomic Substance Transaction penalty⁹
- (2) Interest Based penalty¹⁰.

Forgone Revenue

Under Option 1, California agreed to forgo certain penalties totaling approximately \$55 million. Unlike the general amnesty programs that determine forgone revenue by the amount of penalties assessed but waived under amnesty, the amount of revenue forgone for VCI purposes includes a subjective determination regarding potential penalty amounts. The estimate of forgone revenue is based on the amount of additional tax reported by Option 1 taxpayers and assumes FTB would have:

- Audited and disallowed the tax shelter issue, and
- Assessed the accuracy-related penalty¹¹.

As a result of taxpayers participating in the VCI, FTB waived \$5 million in penalties previously assessed on notices of deficiency. This amount is included in the estimate of \$55 million.

Revenue loss due to redirection of resources from normal audit workloads to abusive tax shelters was addressed as part of the audit workplan process. Since the VCI effort was part of the universe of abusive tax shelter workloads, there is no additional revenue loss¹² from the redirection of resources.

Program costs

To administer the program, FTB staff spent over 19,000 hours (or 11 personnel years) on implementation activities to administer the VCI program for total program costs of \$886,000.

The next section discusses California's strategy for addressing abusive tax shelters.

⁹ California Revenue and Taxation Code section 19774.

¹⁰ California Revenue and Taxation Code section 19777.

¹¹ For this estimate, only the accuracy related penalty is used since that penalty was the only penalty applicable to the audit inventory before the passage of the tax shelter legislation (SB 614). Without the legislation, we would not have the VCI or the increased tax shelter penalties to assess.

¹² This does not include revenue loss from displaced workloads.

California's Strategy for Addressing Abusive Tax Shelters

California used a comprehensive strategy to maximize compliance while conserving resources based on lessons learned from other agencies. Our strategy consisted of three primary components:

- Compliance mechanisms to promote self-compliance and discourage buying and selling of abusive tax shelter products.
- Detection efforts to identify noncompliant taxpayers.
- Enforcement measures to address taxpayers continuing to engage in abusive transactions.

Compliance Strategy

In 2001, California identified about 40 tax shelter cases. In less than two years, this number swelled to 400 tax shelter cases. California sought new compliance strategies since its traditional business approach would not suffice.

Taxpayers were encouraged to voluntarily amend returns for tax shelter items to minimize penalties. When the IRS announced its Offshore Voluntary Compliance Initiative (OVCI) in 2003, California was the first state to support taxpayer participation in the IRS initiative by offering participants similar relief if they also corrected their California tax returns. This resulted in California taxpayers voluntarily reporting over \$5 million in accelerated state tax revenues.

In July 2003, the University of California, Davis Center for State and Local Taxation, the California Research Bureau California State Library, and the FTB held an Abusive Tax Schemes Symposium to an audience of media, legislators, and tax practitioners. The symposium centered on the depth of the tax shelter problem and current government enforcement activities, including the lack of effective deterrents and loopholes that allowed tax shelter investors and promoters to escape significant penalties. The symposium helped convince the media, legislators and tax professionals of the need for tougher measures to encourage self-compliance and penalize those playing “audit roulette.”

California officials worked with academia and tax professionals to examine the tax shelter phenomenon and identified ways to combat the problem. Various federal legislative proposals were reviewed and a modified version was chosen to address issues facing California. On October 2, 2003, California enacted tax shelter legislation that provided vital tools needed to curtail abusive tax shelters.

The new law provided a comprehensive approach to combating abusive tax shelters by including incentives to comply and severe consequences for continued noncompliance. The main purpose of the law was creating the VCI, which allowed taxpayers to comply before California advanced its enforcement efforts. The law includes sizeable new penalties and a reporting regime patterned after the federal requirements for disclosing potentially abusive transactions. These provisions are summarized below. The entire text of the new law is at Appendix A.5.

Voluntary Compliance Initiative ([Appendix A.1](#))

- Offered January 1, 2004 through April 15, 2004.
- Provided taxpayers two options to participate.

Penalties ([Appendix A.2](#))

- A retroactive penalty based on 40 percent of understatements lacking economic substance.
- A retroactive penalty equal to 100 percent of the accrued interest on deficiencies related to tax shelters.
- A prospective penalty equal to 30 percent of understatements from undisclosed reportable transactions.
- A prospective promoter penalty equal to 50 percent of the promoter's gross income derived from promoting tax shelters.
- Prospective penalties for failing to report, register, or disclose required information regarding abusive tax shelters and transactions.

Reporting Requirements ([Appendix A.3](#))

- Conformed to federal return disclosure and list maintenance requirements for reportable transactions.
- Expanded California's tax shelter registration requirements.
- Required organizers selling listed transactions after February 28, 2000, and before January 1, 2004, to register those transactions and provide California with a list of their investors by April 30, 2004.

Other Curtailments ([Appendix A.4](#))

- Extended from four years to eight the statute of limitations for California to issue a deficiency notice regarding tax shelters effective for open years.
- Eliminated the suspension of interest provisions for tax shelter assessments.
- Expanded the FTB's ability to issue subpoenas to taxpayers involved in abusive tax schemes.
- Expanded the FTB's ability to obtain an injunction against abusive tax shelter promoters from marketing shelters within California.

The FTB publicized the VCI to maximize public awareness of and participation in the program. FTB staff focused the marketing campaign on the members of the public most likely to participate in the VCI, informing them of the VCI, the consequences of continued failure to comply, and the new reporting requirements. Between December 2003 and March 2004, approximately 32,000 letters¹³ were mailed to taxpayers describing the benefits of the initiative. Recipients included taxpayers, practitioners, partners of law and accounting firms, and leads received from the IRS, other states and other sources. Additional letters were mailed to tax professionals and potential tax shelter promoters outlining the new reporting requirements and penalties.

Taxpayers also were encouraged to participate through news conferences, press releases, and presentations to tax professional organizations. California State Controller Steve Westly held

¹³ See [Appendix B.6](#) Franchise Tax Board VCI Letters

three news conferences publicizing the VCI and encouraged participation to avoid penalties later. Media activities resulted in California obtaining over 100 print stories (some in nationally syndicated papers), 9 radio and television stories, and 20 Internet news stories¹⁴.

We implemented a variety of information resources for taxpayers and tax practitioners:

- An Abusive Tax Shelters webpage on the Internet (FTB's website) provided timely and relevant information for taxpayers, practitioners and promoters. The website contained publications, frequently asked questions¹⁵, summary of relevant penalties, reporting requirements, links to IRS information and other public information on the abusive tax shelter program.
- VCI brochures¹⁶ distributed through public service offices and tax professional forums.
- A VCI telephone hotline and e-mail address answered over 1,100 telephone calls and 100 email inquiries.

Detection Activities

In September 2003, California and 48 other states signed a Memorandum of Understanding (MOU¹⁷) with the IRS for sharing information and coordinating enforcement efforts relating to abusive tax avoidance transactions. The MOU enhances the exchange of information on compliance initiative programs, litigation, types of schemes, investor and promoter lists, staff training and publicity. In February 2004, the IRS provided over 20,000 tax shelter leads to state taxing agencies on taxpayers involved in offshore transactions, abusive trusts, employee leasing, home-based businesses, employment taxes and other tax-avoidance schemes. Through the agreement, the IRS provides information to the states on a semi-annual basis. Publicizing the sharing of these leads and reinforcing the cooperation between tax administrators helped spur taxpayer interest in California's VCI.

On March 4, 2004, California, and other participating states ratified a Memorandum of Agreement (MOA¹⁸) to share information about abusive tax schemes. As of June 2004, 41 states, the District of Columbia and the City of New York joined in the agreement. The MOA streamlines and facilitates the exchange of information among the states, promotes consistency, maximizes resources and prevents duplication of effort. The MOA allows the states to share names of participants in abusive tax schemes, training materials, and other related information. The states share information through a central database.

California's tax shelter legislation increased the reporting and disclosure requirements for potentially abusive tax shelters. It also broadened the number of tax shelters required to register with California to include transactions with any connection (income, business activity, investor) to California. To increase California's knowledge of those who used potentially abusive tax shelters, the legislation added a requirement for organizers who sold any listed transactions since

¹⁴ See [Appendix C](#)

¹⁵ See [Appendix B.4 for the Frequently Asked Questions](#)

¹⁶ See [Appendix B.5 for the Franchise Tax Board VCI Brochure](#)

¹⁷ See [Appendix D.1. for a complete copy of the IRS MOU](#)

¹⁸ See [Appendix D.2. for a complete copy of the states MOA](#)

February 28, 2000¹⁹ to automatically provide a list of the taxpayers purchasing those transactions.

Enforcement Activities

California is vigorously pursuing tax shelter audits and expanding its focus on curtailing abusive tax shelters. A key strategy is to complement the enforcement activities of the IRS and other states, seeking joint opportunities to maximize efficiencies and avoid duplication by:

- Coordinating audit activities with IRS and other states.
- Utilizing technology solutions to effectively identify audit candidates.
- Conducting joint promoter audits with the IRS and other states to obtain information regarding investors, promoters, marketing strategies, and technical arguments.
- Issuing subpoenas, if necessary, to get information needed to complete our examinations.

Equipped with sizeable new penalties, we began to crack down on promoters of abusive tax shelters. In early 2004, we issued subpoenas and requested client lists from insurance companies believed to be insuring clients who invested in abusive tax shelters against government action.

In August 2004, the FTB jointly hosted an abusive tax shelter symposium with the Multistate Tax Commission and the Federation of Tax Administrators. The symposium enhanced partnering relationships between the 29 attending states and the IRS while accelerating awareness of the national problem and solidified the commitment of the taxing agencies to boost their curtailment efforts. As a result of the success of the VCI program, other states have sought similar legislation.

To further focus our enforcement efforts, FTB formed an Abusive Tax Shelter Unit and supporting teams to keep our information on abusive tax shelters up to date. To ensure we remain have the best information, FTB retained consultants including economists, appraisers and other financial experts to help staff unravel the complex tax schemes.

VCI Lessons Learned

California learned many important lessons while administering the VCI. The knowledge among tax advisors that there is no better deal waiting down the road is critical to the success of any initiative. The following lessons learned may assist other tax officials seeking to administer a tax shelter initiative:

- Dedicate funds and experienced resources to target abusive tax shelters.
- There is no quick fix. Tax shelter issues are constantly evolving, so your overall program strategy must be flexible. In addition to implementing the initiative, long-term resources and funding are needed for detection and enforcement.
- Actively coordinate communications within your department and with other taxing agencies. Information sharing is critical to detection and enforcement efforts. Noncompliant taxpayers thrive on silence.

¹⁹The reference to the February 2000 date is based on the changes to the Treasury regulations involving reportable transactions; Treasury Regulations Sections 1.6011, 1.6111 and 1.6112.

- Gain the authority to take the strong actions needed to influence taxpayer behavior. Adequate enforcement tools are required. Individuals creating, promoting and using abusive transactions are rarely swayed by penalties, reporting requirements or demands for information unless there are significant consequences and those consequences are enforced. . Noncompliant taxpayers and advisors bet that tax administrators will be too strapped and under-funded to take effective action. They must be proven wrong.
- Publicize your department's actions in cracking down on abusive tax shelters to create credibility. Take an active role in directing publicity to those taxpayers most likely to participate. A taxing agency's message must be clearly stated and consistently sent. Inconsistent messages or treatment dilute the effectiveness of any compliance or enforcement effort.
- Detection and enforcement are key to an effective response. An initiative administered without strong detection and enforcement efforts will likely not succeed.

The next section compares California's VCI with the Internal Revenue Service's tax shelter initiatives.

Comparison with Internal Revenue Service Tax Shelter Initiatives

Most state tax amnesty programs are open to the general taxpaying public for various types of taxes. However, no other state had previously opened an amnesty program for taxpayers using abusive tax shelters. Therefore, there are no statistics available to compare California's VCI with tax shelter initiatives from other states (at the time this report was prepared).

The IRS is the only other tax agency that offers initiatives for abusive transactions. They carefully design their tax shelter litigation and settlement strategies for each transaction based on a fair assessment of the litigation hazards to the government and to the taxpayer. A decision to pursue a settlement initiative as to any particular tax avoidance transaction requires careful analysis and balancing of all competing interests and considerations.

Settlement initiatives for abusive tax avoidance transactions may significantly affect taxpayers' voluntary compliance and public confidence. The voluntary compliance system depends on taxpayers knowing tax administrators enforce the tax law against everyone. The IRS increased their enforcement efforts to focus on the rise of abusive tax avoidance transactions and publicized their numerous enforcement successes. The following IRS activities highlighted the size of the problem, the seriousness of the government crackdown, and served as a catalyst for California's success:

- From December 2001 to April 2002, a disclosure initiative resulted in 1,690 transaction disclosures from 1,212 taxpayers. The disclosed transactions involved \$30 billion in claimed losses and deductions.
- From October 2002 through March 2003, other initiatives allowed taxpayers engaged in corporate owned life insurance (COLI), IRC sections 302 and 318 basis shifting, and IRC section 351 contingent liability transactions to resolve their tax consequences arising from their participation in these transactions.
- Since 2002, IRS Large and Mid-Size Businesses Division issued hundreds of administrative summonses in numerous promoter cases. They also obtained court order approval to serve John Doe summonses and the Justice Department filed summons enforcement actions against several promoters.
- From January 2003 through April 2003, an initiative allowed taxpayers using abusive offshore financial arrangements and products to escape criminal prosecution if they disclosed their promoter information. More than 1,300 taxpayers applied and so far the initiative has yielded more than \$170 million in taxes, interest and penalties. The IRS obtained the names of 479 promoters, nearly half of them previously unknown.

The next section concludes this report.

Conclusion

The California Voluntary Compliance Initiative for abusive tax shelters was successful by several measures. While it broke national records for revenues reported during an initiative, the biggest success was self-compliance. During the brief period of the VCI, over 1,200 taxpayers—business entities and individuals—filed over 2,200 amended returns to eliminate tax shelter benefits and comply. Correcting these transactions provided California with \$1.4 billion in income tax revenues.

The VCI's success is largely due to the comprehensive approach of combining a compliance incentive with strong consequences to achieve desired behaviors. The joint efforts with the IRS and other state taxing agencies provided California lawmakers with the information they needed to enact the toughest enforcement and penalty provisions combined with a one-time compliance offer. Together, these provisions have allowed California to make a large impact on abusive tax shelters for returns already filed, while allowing California tax officials to more efficiently pursue future abusive tax shelter transactions.

California remains diligent in its compliance and enforcement efforts and is taking a united approach with the IRS and other state tax administrators in combating abusive tax avoidance transactions.

Addendum

Since April 2004, post-VCI activities at the federal level include:

- IRS offered a settlement initiative for investors of Son of Boss transactions. The IRS announced on May 5, 2004 that taxpayers had until June 21, 2004 to file Notices of Elections to settle. Over 1,500 taxpayers participated, which is about 85% of the Son of Boss taxpayers known to the IRS. See [Appendix D.2.3](#) for more information.
- President Bush signed the American Jobs Creation Act of 2004 that contained tax shelter penalty and curtailment provisions. See [Appendix A.6](#) for a chart comparing the new federal tax shelter provisions to California's current tax shelter provisions.

Since April 2004, post-VCI Activities among the states include:

- California received the following information from their new reporting requirements:
 - 2,000 disclosures of reportable transactions (IRS Form 8886).
 - 950 tax shelter registrations (IRS Form 8264).
 - 9,900 client names who participated in reportable transactions
- [Connecticut](#) ran an abusive tax shelter compliance initiative from June 16, 2004 through July 31, 2004. Taxpayers had until September 30, 2004 to submit information. No final results posted.
- Illinois enacted a [Voluntary Compliance Program](#) (VCP) to give taxpayers an opportunity to file and pay any tax liability from participating in a tax avoidance transaction before their new penalties related to abusive tax shelters go into effect. The VCP started October 15, 2004 and ends January 31, 2005.
- Four additional states signed the States Abusive Tax Shelter Memorandum of Agreement bringing the total to 45 states plus New York City and District of Columbia. The five

states that had not signed the agreement were Florida, Mississippi, Nevada, New Hampshire, and Wyoming.

- Based on the States Abusive Tax Shelter Memorandum of Agreement, New York Department of Revenue completed the Multi State Tax Shelter (MSTS) Application. The MSTS is a secure web-based database allowing states to exchange data on tax shelter participants and information.

Appendices

Appendix A - California Law Statutes 2003, Chapter 656 (Senate Bill 614)

- A.1 Voluntary Compliance Initiative provisions
- A.2 Penalty provisions
- A.3 Reporting Requirement provisions
- A.4 Other curtailment provisions
- A.5 All provisions of Senate Bill 614
- A.6 Chart comparing federal H.R. 4520 to California SB 614

Appendix B -Voluntary Compliance Initiative

- B.1 Participation Agreement (Individuals) and Instructions (Form FTB 622)
- B.2 Participation Agreement (Business Entities) and Instructions (Form FTB 621)
- B.3 Request for Chief Counsel to Relieve Penalties (Form FTB 626)
- B.4 Frequently Asked Questions
- B.5 Franchise Tax Board VCI Brochure
- B.6 Franchise Tax Board VCI Letters
 - B.6.1 Letters mailed to Promoters in February 2004
 - B.6.2 Letters mailed to Other Leads in February 2004
 - B.6.3 General notification letters mailed in March 2004
- B.7 VCI graphs and charts of statistics
 - B.7.1 Summary of VCI by Options- Chart
 - B.7.2 Summary of VCI Revenues by Options- Graph
 - B.7.3 Summary of VCI Taxpayers by Options- Graph
 - B.7.4 VCI Returns by Tax Year- Graph and Table
 - B.7.5 Analysis of VCI by Taxpayer Type-Graph
 - B.7.6 Summary of VCI Participation by States-Table
 - B.7.7 Summary of VCI Participation by Taxpayer Type
 - B.7.8 Illustration of Tax Shelter Penalties before and after legislation

Appendix C - Media

- C.1 Franchise Tax Board Press Releases
 - C.1.1 July 15, 2004-FTB Adds Tax Expert to Its Abusive Tax Shelter Team
 - C.1.2 June 10, 2004-Westly Tax Cheat Crackdown Shrinks Budget Gap
 - C.1.3 April 22, 2004-Westly Announces \$838 Million Windfall Will Help Budget Deficit
 - C.1.4 April 15, 2004-Penalty-Free Program for Tax Shelters Ends Today
 - C.1.5 April 12, 2004-State to Serve First of Tax Shelter Subpoenas
 - C.1.6 April 09, 2004-Illegal Tax Shelter Crackdown Tops \$200 Million Mark
 - C.1.7 April 7, 2004-Controller Westly, Board Of Equalization Member Chiang, Majority Leader Frommer Warn Corporate Tax Cheats Of Stiff Penalties For Illegal Tax Shelters

- C.1.8 March 25, 2004-CPA Firms Targeted in Abusive Tax Shelter Crackdown
- C.1.9 March 22, 2004-Taxpayers Under IRS Audit Urged to Apply for VCI - Penalty Waiver
- C.1.10 March 17, 2004-Westly Proposes \$1 Billion Plan to Help Close Budget Gap
- C.1.11 March 11, 2004-Latest Tax Shelter Crackdown Targets Promoters
- C.1.12 March 04, 2004-States Sign Anti-Abusive Tax Shelter Agreement
- C.1.13 February 19, 2004-Illegal Tax Shelter Crackdown Hits \$100 Million
- C.1.14 February 9, 2004-FTB Information Releases
- C.1.15 January 22, 2004-States Huddle to Plan Offensive Against Abusive Tax Shelters
- C.1.16 January 07, 2004-Tax Shelter Crackdown Nets \$30 Million
- C.1.17 December 03, 2003-New Program Cracks Down on Illegal Tax Shelters
- C.1.18 November 11, 2003-Controller Westly Sends Tax Shelter Expert to Testify at Congressional Hearing
- C.1.19 September 9, 2003-State and Feds Partner to Crackdown on Illegal Tax Schemes
- C.1.20 August 5, 2003-California Targets Abusive Tax Shelters with New Round of Audits
- C.1.21 March 14, 2003-No Jeopardy for State Taxpayers who participate in the IRS' Offshore Voluntary Compliance Initiative, says FTB
- C.1.22 February 10, 2003-FTB Urges Participants in the IRS' Offshore Voluntary Compliance Initiative to Correct State Returns Too
- C.2 Television Programs
 - C.2.1 CBS 60 Minutes-transcript
 - C.2.2 PBS Frontline-transcript

Appendix D - References

- D.1 United States Congress
 - D.1.1 United States Tax Shelter Industry: The Role of Accountants, Lawyers, And Financial Professionals-Four KMPG Case Studies: FLIP, OPIS, BLIPS, and SC2
 - D.1.2 U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals-Vol. I
 - D.1.3 U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals-Vol. II
 - D.1.4 U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals-Vol. III
 - D.1.5 U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals-Vol. IV
 - D.1.6 Fishtail, Bacchus, Sundance, & Slapshot: Four Enron Transactions funded by U.S. Financial Institutions January 2, 2003
 - D.1.7 Testimony of Debra Petersen of the California Franchise Tax Board before the United States Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs on November 18, 2003

- D.1.8 Testimony of Debbie Langsea of the California Franchise Tax Board before the United States Senate Finance Committee on July 21, 2004
- D.2 Internal Revenue Service
 - D.2.1 Internal Revenue Service Abusive Tax Avoidance Transactions Memorandum of Understanding
 - D.2.2 United States General Accounting Office Report, April 2002, Internal Revenue Service, Enhanced Efforts to Combat Abusive Tax Schemes- Challenges Remain.
 - D.2.3 IRS Son of Boss Settlement Information
- D.3 States
 - D.3.1 State Abusive Tax Avoidance Transaction Memorandum of Agreement
 - D.3.2 State of Connecticut Abusive Tax Shelter Compliance Initiative
 - D.3.3 State of Illinois Voluntary Compliance Program

Comparison of New Federal Tax Shelter Law to California's Current Tax Shelter Law

As of October 27, 2004

STATUTE TITLE	SB 614 California Tax Shelter Law	2004 HR.4520 American Jobs Creation Act
INVESTOR PENALTIES		
Non-economic substance transaction	<ul style="list-style-type: none"> ▪ Penalty is: <ul style="list-style-type: none"> - 20% of understatement if adequately disclosed. - 40% of understatement if not adequately disclosed. ▪ FTB Chief Counsel may rescind reportable transaction penalty. No appeal for refusal to rescind penalty 	<ul style="list-style-type: none"> ▪ None
Reportable transaction understatement	<ul style="list-style-type: none"> ▪ Penalty is: <ul style="list-style-type: none"> - 20% if transaction adequately disclosed. - 30% if transaction not adequately disclosed. ▪ The 20% penalty can only be avoided if the taxpayer (1) satisfies "strengthened reasonable cause" exception and (2) has been contacted by the FTB regarding a potentially ATS. ▪ FTB Chief Counsel may rescind the penalty. No appeal for refusal to rescind penalty. 	<ul style="list-style-type: none"> ▪ Penalty is the same as CA. ▪ The 20% penalty can only be avoided if the taxpayer satisfies the "strengthened reasonable cause" exception. ▪ Any understatement upon which penalty is imposed is not subject to the valuation misstatement penalty under Sections 6662(e) and (h).
Failure to disclose reportable transaction	<ul style="list-style-type: none"> • Penalty is: <ul style="list-style-type: none"> - \$15K for reportable transactions. - \$30K for listed transactions. • Applies only to large entities or high 	<ul style="list-style-type: none"> • Penalty is <ul style="list-style-type: none"> - \$10K – individuals; increased to \$100K for listed transaction. - \$50K – all other taxpayers;

Comparison of New Federal Tax Shelter Law to California's Current Tax Shelter Law

As of October 27, 2004

STATUTE TITLE	SB 614 California Tax Shelter Law	2004 HR.4520 American Jobs Creation Act
	<p>net worth individuals.</p> <ul style="list-style-type: none"> • FTB Chief Counsel may rescind reportable transaction penalty. No appeal for refusal to rescind penalty. • Applies to taxable years beginning on or after January 1, 2003, except for: <ol style="list-style-type: none"> (1) Taxpayers who invested in a transaction after February 28, 2000 and before January 1, 2004, and that transaction becomes listed at any time, or (2) Taxpayers who invested in California listed transactions on or after September 2, 2003. 	<p>increased to \$200K for listed transaction.</p> <ul style="list-style-type: none"> • Commissioner may rescind reportable transaction penalty. No judicial appeal for refusal to rescind penalty. • IRS must send Congress an annual report summarizing application of penalties, description of penalties rescinded and reason for rescission. • A public entity required to pay a penalty for failing to disclose a listed transaction must disclose the imposition of the penalty in reports to the SEC for the period as the Secretary shall specify.
Frivolous submission penalty	<ul style="list-style-type: none"> ▪ Penalty is \$5000 for submitting a "specified frivolous submission". ▪ FTB Chief Counsel may rescind penalty. No appeal for FTB's refusal to rescind penalty. 	<ul style="list-style-type: none"> ▪ None
Frivolous return penalty	<ul style="list-style-type: none"> ▪ Penalty is \$5000 if FTB contacts taxpayer regarding a potentially ATS. ▪ FTB Chief Counsel may rescind penalty. No appeal for FTB's refusal to rescind penalty. 	<ul style="list-style-type: none"> ▪ No change to existing federal law. Current penalty is \$500.
Accuracy related penalty changes	<ul style="list-style-type: none"> • Modifies definition of "substantial" for corporate taxpayers contacted by FTB regarding potentially abusive tax shelter. 	<ul style="list-style-type: none"> • Modifies definition of "substantial" for corporate taxpayers. • A corporate taxpayer has a substantial understatement if the amount of the

Comparison of New Federal Tax Shelter Law to California's Current Tax Shelter Law

As of October 27, 2004

STATUTE TITLE	SB 614 California Tax Shelter Law	2004 HR.4520 American Jobs Creation Act
	<ul style="list-style-type: none"> Corporate taxpayer has a substantial understatement if the understatement for taxable year exceeds the lesser of (1) 10% of tax required to be shown on the return (or, if greater, \$2,500), or (2) \$5 M. Elevates the standard a taxpayer must satisfy to reduce the amount of the understatement for items not adequately disclosed. The understatement is only reduced if taxpayer had a reasonable belief that the tax treatment was more likely than not the proper treatment. 	<p>understatement for the taxable year exceeds, the lesser of (1) 10% of tax required to be shown on return (or, if greater, \$10K), or (2) \$10 M.</p> <ul style="list-style-type: none"> Does not raise standard to "more likely than not".
Waive suspension of interest	<ul style="list-style-type: none"> Interest not suspended for individual taxpayers with revised taxable income greater than \$200K if FTB contacts the taxpayer regarding the use of a potentially ATS. 	<ul style="list-style-type: none"> No change to existing federal law, which allows suspension of interest on tax shelter assessments.
Interest Based Penalty	<ul style="list-style-type: none"> Penalty is equal to 100% of the accrued interest on the underpayment of tax if taxpayer contacted by FTB regarding a potentially ATS. 	<ul style="list-style-type: none"> None
Qualified amended return interest rate	<ul style="list-style-type: none"> Amended returns self-assessing tax that are filed after 4/15/04 are subject to a 50% increased interest rate for understatements of tax related to a reportable transaction. 	<ul style="list-style-type: none"> None

Comparison of New Federal Tax Shelter Law to California's Current Tax Shelter Law

As of October 27, 2004

STATUTE TITLE	SB 614 California Tax Shelter Law	2004 HR.4520 American Jobs Creation Act
PROMOTER/ORGANIZER PENALTIES		
Promoter penalty	<ul style="list-style-type: none"> • Penalty is 50% of gross income derived by the person from the activity. • Does not apply to a gross valuation overstatement. 	<ul style="list-style-type: none"> • Same
Failure to register tax shelter	<ul style="list-style-type: none"> • Penalty for failing to register tax shelter or filing incomplete registration. - \$15K • Penalty for listed transaction is the greater of: (1) \$100K, or (2) 50% of gross income derived from the activity. Intentional disregard – penalty is 75% of gross income. • FTB Chief Counsel cannot waive penalty for listed transactions. No right to appeal refusal to rescind penalty. 	<ul style="list-style-type: none"> • Repealed registration regime and associated penalties. • Created information return reporting requirements.
Failure of Material Advisor to File Information Return for Reportable Transactions	<ul style="list-style-type: none"> ▪ None 	<ul style="list-style-type: none"> ▪ Penalty - \$50K ▪ For listed transaction penalty is greater of: (1) \$200K, or (2) 50% gross income with respect to the transaction. Intentional disregard – penalty is 75% of gross income. • Commissioner cannot waive penalty with respect to listed transaction. No right to judicial appeal for refusal to rescind penalty. • IRS must send Congress an annual

Comparison of New Federal Tax Shelter Law to California's Current Tax Shelter Law

As of October 27, 2004

STATUTE TITLE	SB 614 California Tax Shelter Law	2004 HR.4520 American Jobs Creation Act
		report summarizing application of penalties, description of penalties rescinded and reason for rescission.
Failure to Provide Investor List for Reportable Transactions	<ul style="list-style-type: none"> • Penalty is \$10K a day after 20th day for reportable transactions. • Licensed attorneys, who are material advisors due solely to the practice of law, do not have to maintain investor lists if a transaction was entered into before January 1, 2004. • SOL for imposing penalty is 8 yrs after failure to provide or maintain list. • FTB Chief Counsel can only waive penalty for reportable transactions. No right to appeal refusal to rescind penalty. 	<ul style="list-style-type: none"> • Penalty is the same as for CA. • Penalty can be waived if failure to make the list available is due to reasonable cause.
Failure to Automatically Provide Investor List for Listed Transactions	<ul style="list-style-type: none"> • Penalty is the greater of: <ul style="list-style-type: none"> - \$100K, or - 50% of gross income derived from the activity. Intentional disregard – 75% of gross income. • SOL for imposing penalty is 8 yrs after failure to provide or maintain list. • FTB Chief Counsel cannot waive penalty for listed transactions. No right to appeal refusal to rescind penalty. 	<ul style="list-style-type: none"> ▪ None
Preparer penalty	<ul style="list-style-type: none"> ▪ Penalty - \$1000. If willful/reckless conduct - \$5,000 ▪ Replaced “possibility standard” with 	<ul style="list-style-type: none"> ▪ No change to existing federal law. Current penalty is \$250. ▪ If willful/reckless conduct penalty

Comparison of New Federal Tax Shelter Law to California's Current Tax Shelter Law

As of October 27, 2004

STATUTE TITLE	SB 614 California Tax Shelter Law	2004 HR.4520 American Jobs Creation Act
	<p>requirement that there be a reasonable belief the tax treatment of the position was more likely than not standard.</p> <ul style="list-style-type: none"> ▪ Replaced the not frivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position. 	<p>increased to \$1000.</p>
Extended SOL	<ul style="list-style-type: none"> ▪ FTB has 8 years after taxpayer files a return to mail a proposed deficiency assessment relating to an abusive tax avoidance transaction. 	<ul style="list-style-type: none"> ▪ If listed transaction not properly disclosed on return, the SOL is extended 1 year after the earlier of the date: <ul style="list-style-type: none"> (1) Disclosure information is furnished to IRS, or (2) Material advisor satisfies list maintenance requirements with respect to IRS request.
Confidentiality related to taxpayer communications	<ul style="list-style-type: none"> ▪ Communications with respect to tax shelters are not subject to the confidentiality provision that applies to communications between a taxpayer and a tax practitioner. ▪ Ch. 412 (AB 1416) extends repeal date from 1/1/05 to 1/1/09. 	<ul style="list-style-type: none"> ▪ Same – except no sunset date.
Tax Shelter Injunctions	<ul style="list-style-type: none"> • An injunction may be sought against a material advisor to enjoin the advisor from failing to: <ul style="list-style-type: none"> (1) File an information return with respect to a reportable transaction, or (2) Maintain, or to timely furnish upon 	<ul style="list-style-type: none"> • Same • May also seek injunctions for violations of any of the rules under Circular 230.

Comparison of New Federal Tax Shelter Law to California's Current Tax Shelter Law

As of October 27, 2004

STATUTE TITLE	SB 614 California Tax Shelter Law	2004 HR.4520 American Jobs Creation Act
	written request by FTB, a list of investors for each reportable transaction.	
Interest Deduction	<ul style="list-style-type: none">Allows deduction for interest paid on underpayment of tax attributable to potentially ATS.	<ul style="list-style-type: none">Disallows deduction for interest paid or accrued within a taxable year on underpayment of tax attributable to non-disclosed reportable and listed transactions.

Voluntary Compliance Participation Agreement Form

(Individual Income Taxpayers)

Please refer to the instructions for more information. When completed and signed by an authorized representative, this form will serve as the official agreement with the Franchise Tax Board.

Attach to the Amended Individual Income Tax Return

For calendar year _____, or Fiscal year beginning month _____ day _____ year _____, and ending month _____ day _____ year _____.	
Your name as shown on return	Your Social Security Number:
Spouse's name as shown on return (if married filing jointly)	Spouse's Social Security Number:
Address	<p style="text-align: center;">▲ Important ▲</p> <p style="text-align: center;">You must enter Your SSN(s) above</p>

Select one:

Check one of the following Options and attach this form to each amended return. You must elect the same option for each year of participation.

Option 1 <input type="checkbox"/> I elect to participate in the VCI under Option 1. I understand that I waive my right to appeal or file a claim for refund for any amounts paid under this VCI.
Option 2 <input type="checkbox"/> I elect to participate in the VCI under Option 2. I understand this option will not affect my right to appeal or file a claim for refund for any amounts paid under this VCI.
Please check if either of the following boxes applies. <input type="checkbox"/> A. I want to treat this election as a claim for refund. My basis for the claim is attached. <input type="checkbox"/> B. I do not want to treat this election as a claim for refund. I just want to maintain my appeal rights. <input type="checkbox"/> C. I have a pending federal action and want to treat this election as a claim for refund. My basis for the claim is attached.
For more details, please see the instructions to this form under Option 2 Appeal Process.
PLEASE SIGN BELOW Under penalty of perjury of the laws of the State of California, I declare that I examined this form, including any accompanying statements, and to the best of my knowledge and belief it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge. I am properly authorized to execute this form. Your name (please print): _____ Spouse's name (please print): _____ Your signature: _____ Spouse's signature: _____ Date: _____ Telephone number: _____ Date: _____ Telephone number: _____ Note: A <i>Participation Agreement</i> signed by a representative or an attorney-in-fact must be accompanied by a completed power of attorney (Form FTB 3520) authorizing such signature. For Privacy Act Notice, get form FTB 1131.

Instructions for form FTB 622

Voluntary Compliance Initiative - Participation Agreement for Individual Income Taxpayers

These instructions are based on California Revenue and Taxation Code Sections 19751-19754.

A General Information

The Franchise Tax Board (FTB) Voluntary Compliance Initiative (VCI) program is for taxpayers who underreported tax liabilities due to the use of abusive tax shelters and transactions. The VCI is available only from January 1, 2004, through April 15, 2004, and applies to 2002 and all prior taxable years. An abusive tax shelter and transaction is any plan or arrangement devised for the principal purpose of avoiding tax.

To participate in the VCI:

- You amend your California return by eliminating your abusive tax avoidance transactions and fully pay all taxes and interest due. If you are unable to pay, the FTB may enter into an installment payment agreement with you.

Refer to the FTB 3561 booklet on our Website at www.ftb.ca.gov, under Voluntary Compliance Initiative.

Write "VCI" in red on the top of your installment agreement request and send it to:

Franchise Tax Board
PO Box 2952
Sacramento CA 95812-2952

- The FTB will waive all penalties (except those penalties finalized prior to December 31, 2003) applicable to abusive tax shelter and transactions for taxable years the taxpayer participates in the VCI Option 1. See VCI Option 2 below for exceptions.
- The FTB will not pursue criminal action for taxable years with respect to the VCI issues if a criminal complaint was not filed against you or you are not the subject of a criminal investigation in connection with an abusive tax shelter and transaction as of December 31, 2003.

B Eligibility

The VCI applies to any taxpayer that meets all of the following:

- 1) Previously filed a California franchise or income tax return using an abusive tax shelter and transaction to underreport tax liability.
- 2) Was not eligible to participate in the IRS Offshore Voluntary Compliance Initiative that ended April 15, 2003.
- 3) Was not party to a filed criminal complaint or under criminal investigation for an abusive tax shelter and transaction as of December 31, 2003.

C Options

If you are participating in more than one year, you must elect the same option for each year.

Option 1 – Waive Appeal Rights

You elect to comply by amending your California return reporting all income or loss without regard to an abusive tax shelter and transaction and close the issue with finality.

If you have a final federal determination (such as, revenue agent report, closing or settlement agreement) regarding the transaction, amend your California return based on the final federal determination and attach a copy to your amended return. Be sure to adjust for federal and state differences.

You must fully pay all taxes and interest due as reported on your amended return.

You waive your right to appeal the amounts paid under the VCI in exchange for being relieved of any applicable penalties and avoiding possible prosecution.

Option 2 – Retain Appeal Rights

You elect to comply by amending your California return reporting all income or loss without regard to an abusive tax shelter and transaction but wish to maintain your appeal rights.

If you have a final federal determination (such as, revenue agent report, closing or settlement agreement) regarding the transaction, amend your California return based on the final federal determination and attach a copy to your amended return. Be sure to adjust for federal and state differences.

You must fully pay all taxes and interest due as reported on your amended return.

You avoid possible prosecution, but remain subject to the 20% accuracy related penalty as provided in California Revenue & Taxation Code section 19164 (prior to amendments passed in October 2003).

If you elect this option, you can choose to:

- A. Treat your amended return as your claim for refund, or
- B. File a claim later within the statute of limitations.

In either case, you must clearly state the specific grounds of your claim and attach any necessary documents. Once you file a claim for refund under Option 2, the FTB will process and may examine your claim for refund, or may defer that action if there is a pending federal action, such as, an IRS examination.

The FTB will determine if the accuracy related penalty applies when it takes action on your claim. If there is a final federal determination regarding the transaction and the accuracy related penalty, the FTB will generally follow the federal determination.

Option 2 – Appeal Process:

You may file an appeal after either of the following:

- 1) The FTB takes action on the claim for refund, or
- 2) The later of either:
 - (a) 180 days after the date of a final federal determination regarding an abusive tax avoidance transaction, or
 - (b) 4 years after the date you filed the claim, or if later, 1 year after full payment of tax, penalty and interest.

If the FTB assesses the accuracy related penalty, you must pay the amount before proceeding with your appeal.

D How to Participate

You must file an amended return and attach a completed *Participation Agreement* Form FTB 621 (for corporations, LLCs, partnerships, estates, trusts, and fiduciaries), or Form FTB 622 (for individuals, partners and shareholders). You must file a separate *Participation Agreement* for each year you participate in the VCI. You must elect one of the two options. If you are participating in more than one year, you must elect the same option for each year.

Before attaching the VCI *Participation Agreement* (Form FTB 621 or 622) to the amended return, make sure you fill out the following entries:

- Calendar or fiscal year dates.
- Name.
- Social Security Number.
- Clearly check only one option.
- Signature

Attach the completed VCI *Participation Agreement* form (FTB 621 or 622) to the back of each amended return being filed. On the top of the amended return **write "VCI" in red.**

Amended returns, and payment of the additional tax and interest, must be sent no later than April 15, 2004. Send your amended return(s) to:

Attn: VCI
Franchise Tax Board
PO Box 1673
Sacramento CA 95812-1673

To file the amended return use the following FTB form:

- Corporations – Form FTB 100X for taxpayers who previously filed a

Form FTB 100, 100S, or 100W

- Partnerships – Form FTB 565
- LLC – Form FTB 568 for taxpayers filing as a partnership
- Individuals/Partners/Shareholders – Form FTB 540X
- Estates/Trusts/Fiduciaries – Form FTB 541

E Additional Information

For additional information concerning the Voluntary Compliance Initiative, please refer to one of the following:

- Our Voluntary Compliance Initiative Website at:

www.ftb.ca.gov
- Call the VCI Hotline at (916) 845-3232.
- E-mail us at vci@ftb.ca.gov

Assistance for persons with disabilities:

We comply with the Americans with Disabilities Act. Persons with hearing or speech impairments please call TTY/TDD (800) 822-6268.

Voluntary Compliance Participation Agreement Form

(Business Entities)

Please refer to the instructions for more information. When completed and signed by an authorized representative of your organization, this form will serve as the official agreement with the Franchise Tax Board.

Attach to the Amended Business Entity Tax Return

For calendar year _____, or fiscal year beginning month _____ day _____ year _____, and ending month _____ day _____ year _____	
Business entity name as shown on return and current address	California Business Entity Number:
	Key Corporation Number (If original return was included in an election to file a Unitary Taxpayers' Group return, include a copy of the Schedule R-7):

Select one: Check one of the following Options and attach this form to each amended return. You must elect the same option for each year of participation.

Option 1

- ☐ On behalf of the above-named business entity, I elect to participate in the VCI under Option 1. I understand this option is irrevocable, and waive the entity's right to appeal or file a claim for refund for any amounts paid under this VCI.

Option 2

- ☐ On behalf of the above-named business entity, I elect to participate in the VCI under Option 2. I understand this option will not affect the entity's right to appeal or file a claim for refund for any amounts paid under this VCI option.

Please check if one of the following applies to this election.

- ☐ **A.** The business entity treats this election as a claim for refund. Specific grounds for the claim are described in an attachment.
- ☐ **B.** The business entity does not treat this election as a claim for refund. The business entity maintains its appeal rights.
- ☐ **C.** The business entity has a pending federal action and treats this election as a claim for refund. Specific grounds for the claim are described in an attachment.

For more details, please see the instructions to this form under **Option 2 Appeal Process**.

PLEASE SIGN BELOW

Under penalty of perjury of the laws of the State of California, I declare that I examined this form, including any accompanying statements, and to the best of my knowledge and belief it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge. I am properly authorized to execute this form.

Name of officer or general partner (please print): _____ Title: _____

Signature of officer or general partner: _____ Date: _____

Telephone number: _____

Note: A *Participation Agreement* signed by a representative or an attorney-in-fact must be accompanied by a completed power of attorney (Form FTB 3520) authorizing such signature. For taxpayers who elected to file a Unitary Taxpayers' Group return, see instructions under "How to Participate."

For Privacy Act Notice, get form FTB 1131.

Instructions for form FTB 621

Voluntary Compliance Initiative - Participation Agreement for Business Entity Taxpayers

These instructions are based on California Revenue and Taxation Code Sections 19751-19754

A General Information

The Franchise Tax Board (FTB) Voluntary Compliance Initiative (VCI) program is for taxpayers who underreported tax liabilities due to the use of abusive tax shelters and transactions. The VCI is available only from January 1, 2004, through April 15, 2004, and applies to 2002 and all prior taxable years. An abusive tax shelter and transaction is any plan or arrangement devised for the principal purpose of avoiding tax.

To participate in the VCI:

- You amend your California return by eliminating your abusive tax avoidance transactions and fully pay all taxes and interest due. If you are unable to pay, the FTB may enter into an installment payment agreement with you. To request an installment agreement, contact Office Collections at (916) 845-7033 or send your request to:

Franchise Tax Board - Office Collections
PO Box 942857
Sacramento CA 94857-2021

- The FTB will waive all penalties (except those penalties finalized prior to December 31, 2003) applicable to abusive tax shelter and transactions for taxable years the taxpayer participates in the VCI Option 1. See VCI Option 2 below for exceptions.
- The FTB will not pursue criminal action for taxable years with respect to the VCI issues if a criminal complaint was not filed against you or you are not the subject of a criminal investigation in connection with an abusive tax shelter and transaction as of December 31, 2003.

B Eligibility

The VCI applies to any taxpayer that meets all of the following:

- Previously filed a California franchise or income tax return using an abusive tax shelter and transaction to underreport tax liability.
- Was not eligible to participate in the IRS Offshore Voluntary Compliance Initiative that ended April 15, 2003.
- Was not party to a filed criminal complaint or under criminal investigation for an abusive tax shelter and transaction as of December 31, 2003.

C Options

If you are participating in more than one year, you must elect the same option for each year.

Option 1 – Waive Appeal Rights

You elect to comply by amending your California return reporting all income or loss without regard to an abusive tax shelter and transaction and close the issue with finality.

If you have a final federal determination (such as, revenue agent report, closing or settlement agreement) regarding the transaction, amend your California return based on the final federal determination and attach a copy to your amended return. Be sure to adjust for federal and state differences.

You must fully pay all taxes and interest due as reported on your amended return.

You waive your right to appeal the amounts paid under the VCI in exchange for being relieved of any applicable penalties and avoiding possible prosecution.

Option 2 – Retain Appeal Rights

You elect to comply by amending your California return reporting all income or loss without regard to an abusive tax shelter and transaction but wish to maintain your appeal rights.

If you have a final federal determination (such as, revenue agent report, closing or settlement agreement) regarding the transaction, amend your California return based on the final federal determination and attach a copy to your amended return. Be sure to adjust for federal and state differences.

You must fully pay all taxes and interest due as reported on your amended return.

You avoid possible prosecution, but remain subject to the 20% accuracy related penalty as provided in California Revenue & Taxation Code section 19164 (prior to amendments passed in October 2003).

If you elect this option, you can choose to:

- Treat your amended return as your claim for refund, or
- File a claim later within the statute of limitations.

In either case, you must clearly state the specific grounds of your claim and attach any necessary documents. Once you file a claim for refund under Option 2, the FTB will process and may examine your claim for refund, or may defer that action if there is a pending federal action, such as, an IRS examination.

The FTB will determine if the accuracy related penalty applies when it takes action on your claim. If there is a final federal determination regarding the transaction and the accuracy related penalty, the FTB will generally follow the federal determination.

Option 2 – Appeal Process:

You may file an appeal after either of the following:

- 1) The FTB takes action on the claim for refund, or
- 2) The later of either:
 - (a) 180 days after the date of a final federal determination regarding an abusive tax avoidance transaction, or
 - (b) 4 years after the date you filed the claim, or if later, 1 year after full payment of tax, penalty and interest.

If the FTB assesses the accuracy related penalty, you must pay the amount before proceeding with your appeal.

D How to Participate

You must file an amended return and attach a completed *Participation Agreement*, Form FTB 621, (for corporations, LLCs, partnerships, estates, trusts, and fiduciaries), or Form FTB 622 (for individuals, partners and shareholders). You must file a separate participation agreement for each year you participate in the VCI. You must elect one of the two options. If you are participating in more than one year, you must elect the same option for each year.

Before attaching the VCI *Participation Agreement* (Form FTB 621 or 622) to the amended return, make sure you fill out the following entries:

- Calendar or fiscal year dates.
- Name.
- California identification number.
- Key corporation number and copy of Schedule R-7, if applicable.
- Clearly check only one option.
- Signature of authorized officer.

Note: For taxpayers who elected to file a Unitary Taxpayers' Group return: The individual signing this participation agreement

represents that he or she is an officer of the corporation on whose behalf this participation agreement is being filed and is an officer of all other entities that were members of this unitary business for the taxable year for which this participation agreement is being filed. He or she has authorization to execute this participation agreement on behalf of each and every member of the unitary business for the year for which this participation agreement is being filed.

A member of a Unitary Taxpayers' Group return may elect to enter the VCI program independent of the other members of the group. The affected taxpayer must include a notice of termination of the R-7 group election for the year with the Participation Agreement(s) and amended return(s).

Attach the completed VCI *Participation Agreement* Form (FTB 621 or 622) to the back of each amended return being filed. On the top of the amended return **write "VCI" in red.**

Amended returns, and payment of the additional tax and interest, must be sent no later than April 15, 2004. Send your amended return(s) to:

Attn: VCI
Franchise Tax Board
PO Box 1673
Sacramento CA 95812-1673

To file the amended return use the following FTB form:

- Corporations – Form FTB 100X for taxpayers who previously filed a Form FTB 100, 100S, or 100W

- Partnerships – Form FTB 565
- LLC – Form FTB 568 for taxpayers filing as a partnership
- Individuals/Partners/Shareholders – Form FTB 540X
- Estates/Trusts/Fiduciaries – Form FTB 541

E Electronic Funds Transfer (EFT)

Corporations that meet certain requirements must remit all of their payments through EFT. Payments made by other means may result in a penalty of 10 percent of the amount paid.

To obtain more information on the EFT requirements, please refer to Publication 3817, *Electronic Funds Transfer Information Guide*. If you would like assistance regarding EFT, please call the EFT Unit at (916) 845-4025 Monday through Friday 8 a.m. until 5 p.m. or visit our Website at:

www.ftb.ca.gov

F Additional Information

For additional information concerning the Voluntary Compliance Initiative, please refer to one of the following:

- Visit our Voluntary Compliance Initiative Website at:

www.ftb.ca.gov

- Call the VCI Hotline at (916) 845-3232.
- E-mail us at vci@ftb.ca.gov

Assistance for persons with disabilities:

We comply with the Americans with Disabilities Act. Persons with hearing or speech impairments please call TTY/TDD (800) 822-6268.



REQUEST FOR CHIEF COUNSEL TO RELIEVE PENALTIES

Please see the reverse side of this form for general instructions and mailing information.

Use this form to request relief from a penalty imposed under Revenue and Taxation Code Section 19173, 19179, 19772, 19773, or 19774. **You must complete and send a separate request (form FTB 626) for each penalty for which you want relief.**

Taxpayer Name/Entity	Social Security Number/Entity ID Number
Spouse	Spouse's Social Security Number
Address (number, street, and room, or suite number)	City, State, and ZIP Code
Tax Year (if applicable)	Amount of Penalty

I request that Franchise Tax Board's Chief Counsel relieve the following penalty: (Check one.)

- ☐ Section 19173 - Failure to register or maintain investor lists penalty
- ☐ Section 19179 - Frivolous return penalty
- ☐ Section 19179(d) - Frivolous submission penalty
- ☐ Section 19772 - Failure to disclose reportable transaction penalty
- ☐ Section 19773 - Reportable transaction understatement penalty
- ☐ Section 19774 - Noneconomic substance transaction understatement penalty

I have attached a statement specifying the facts and reasons supporting my request for relief from the above penalty.

Under penalties of perjury, I declare that I have examined this request, including any accompanying schedules and statements; and to the best of my knowledge and belief, it is true, correct, and complete.

Signature (and title if applicable)

Date

Signature

Date

For Privacy Act Notice, get form FTB 1131.

Instructions for form FTB 626

REQUEST FOR CHIEF COUNSEL TO RELIEVE PENALTIES

Purpose of form FTB 626

You can use FTB 626 to request Franchise Tax Board's Chief Counsel relieve certain penalties. The law provides the Chief Counsel with discretion to relieve all or part of these penalties. You can only request relief from penalties listed on the front of form FTB 626.

You must complete a form FTB 626 for each penalty for which you are seeking relief and attach a copy of the notice on which we imposed the penalty. We impose penalties on Notices of Proposed Assessment or billing notices.

Specific Instructions

Social Security Number – Individuals: If your request for penalty relief is related to a joint return, enter social security numbers for both you and your spouse.

Entity Identification Number: If your request for penalty relief is for a corporation, partnership, estate, trust, or an LLC, or other business entity, enter the entity identification number.

Signature – Individuals: If you filed a joint return, and you and your spouse are both requesting relief, both spouses should sign the request.

Signature – Business Entities: An authorized individual must sign requests filed by business entities, and the signature must be accompanied by the individual's title.

Your authorized representative may file form FTB 626 for you. The original copy of a Power of Attorney must be attached to form FTB 626.

Statement: You must attach a statement specifying the facts and reasons supporting your request for relief from the penalty.

Mail your completed request and supporting statement to:

CHIEF COUNSEL
FRANCHISE TAX BOARD LEGAL DEPARTMENT MS B-17
PO BOX 1720
RANCHO CORDOVA CA 95741-1720

For additional penalty information, please go to our Website: www.ftb.ca.gov. You can also contact us by telephone at (800) 852-5711.

Assistance for persons with disabilities: We comply with the Americans with Disabilities Act. Persons with hearing or speech impairments please call TTY/TDD (800) 822-6268.

Option 2 allows you to voluntarily comply while maintaining your appeal rights, allowing you discretion to file a claim for refund for amounts paid under the VCI. In exchange, we waive all penalties that apply to the use of the abusive tax shelter or transaction except for the accuracy-related penalty.

Can I participate in the VCI if I do not have the ability to pay now?

Yes. The VCI requires you to fully pay the tax liabilities and interest for all years you participate in the VCI. However, if the Franchise Tax Board determines you are unable to pay now, based on full disclosure of all your assets and income sources, you may be able to pay the tax and interest in installments over time and qualify for penalty relief under the VCI.

Assistance for persons with disabilities:

We comply with the Americans with Disabilities Act. Persons with hearing or speech impairments, please call TTY/TDD (800) 822-6268.

What if I need forms or additional information about the VCI program?

Contact Information

Internet

www.ftb.ca.gov

Email

vci@ftb.ca.gov

Telephone

(916) 845-3232

Monday - Friday, 9:00 a.m. to 4:00 p.m.

VCI Participation Agreement Form

- Available online at www.ftb.ca.gov
- Call us at (916) 845-3232

Form FTB 622 for Individuals

Form FTB 621 for Business Entities

**Remember, you must act by
April 15, 2004.**

State of California

Abusive Tax Shelters: Need a way out?

**January 1, 2004
to
April 15, 2004**

VCI
Voluntary Compliance Initiative

It's the right choice!

www.ftb.ca.gov

What is the Voluntary Compliance Initiative?

The Voluntary Compliance Initiative (VCI) allows a limited time for taxpayers, who used abusive tax shelters or transactions to underreport their income or tax liability, to amend their returns and obtain a waiver of various penalties. The VCI applies to tax year 2002 and prior tax years.

The VCI begins January 1, 2004, and ends April 15, 2004.

What is an abusive tax shelter or transaction?

Abusive tax shelters or transactions are plans or arrangements devised for the principal purpose of avoiding tax. They include, but are not limited to, listed transactions identified by the Internal Revenue Service (IRS) or the Franchise Tax Board.

Can I participate in the VCI?

You can participate if you used an abusive tax shelter or transaction to underreport your income or tax liability. You cannot use the VCI if you were eligible to participate in the IRS Offshore Voluntary Compliance Initiative (Rev. Proc. 2003-11).

How do I participate in the VCI?

To participate in the VCI, obtain a *Participation Agreement* form from our Website at www.ftb.ca.gov, or call (916) 845-3232 to order the form. Complete the form and attach it to your amended return. Your amended return must report all income and loss without regard to the abusive tax shelter or transaction. You must amend your return and pay all taxes and interest by April 15, 2004.

Why should I participate in the VCI?

You can save a significant amount of money in penalties and avoid possible criminal prosecution. Potential penalties and interest can be substantial. The chart below highlights potential savings for those participating in the VCI:

Payment due with VCI	
Tax	\$100,000
Interest	30,585
Total	\$130,585

Payment due without VCI	
Tax	\$100,000
Interest	30,585
Penalties	145,585
Total	\$276,170

What penalties can I avoid if I participate in the VCI?

The penalties you may avoid include:

Noneconomic Substance Transaction Understatement Penalty	20% or 40% of the underpayment
Accuracy-Related Penalty	20% or 40% of the underpayment
Interest-Based Penalty	Additional 100% of the interest due on the deficiency
Fraud Penalty	Equal to 75% of the underpayment

What are my options under the VCI?

You can choose one of two options under the VCI. Both options require you to amend your California income or franchise tax return to eliminate the abusive tax shelter or transaction and pay tax and interest due.

Option 1 allows you to voluntarily comply without appeal rights. We will waive all penalties that apply to the use of the abusive tax shelter or transaction. Under this option, you cannot file a claim for refund for amounts paid under the VCI related to the abusive tax shelter or transaction.



STATE OF CALIFORNIA
FRANCHISE TAX BOARD
PO Box 1673
Sacramento CA 95812-1673
Telephone (916) 845-3232 Fax (916) 845-0415

Abusive Tax Shelters: Need a Way Out?

March 2004

New California law authorizes the Franchise Tax Board to aggressively combat abusive tax shelters and transactions by adding substantial penalties, along with new registration and reporting requirements for both investors and promoters of abusive tax shelters.

The law also provides an opportunity for taxpayers who underreported their income or tax liability using abusive tax shelters and transactions to amend their returns and limit the risk of penalties, before we step-up our enforcement activities. These penalties are substantial and can range from 20 percent to 75 percent of the underpayment, and include an added penalty equal to 100 percent of the interest charged on any deficiency assessment.

This opportunity to come forward, which by statute is called the Voluntary Compliance Initiative, applies to tax year 2002 and prior tax years. It is effective through April 15, 2004. **To participate in the Voluntary Compliance Initiative** or get more information about the new abusive tax shelter and transaction penalties, read the enclosed brochure, or:

- Visit our Voluntary Compliance Initiative Website at **www.ftb.ca.gov**.
- Email us at vci@ftb.ca.gov.
- Call our Voluntary Compliance Initiative hotline at (916) 845-3232, Monday – Friday, 9:00 a.m. to 4:00 p.m.

This letter constitutes formal notification of the Voluntary Compliance Initiative pursuant to California Revenue and Taxation Code Section 19751(e). If you invested in an abusive tax shelter, and do not participate in this initiative, you cannot avoid the abusive tax shelter and transaction penalties by filing an amended return after April 15, 2004. If you **did not** invest in any abusive tax shelter or transaction, please disregard this letter.

Winston Mah, Chief
Audit Division



STATE OF CALIFORNIA
FRANCHISE TAX BOARD
PO Box 1673
Sacramento CA 95812-1673
Telephone (916) 845-3232 Fax (916) 845-0415

Abusive Tax Shelters: Need a Way Out?

March 2004

Taxpayer Name
Address
Address

California obtained thousands of abusive tax shelter leads from the IRS, states, and other sources of information. These leads identified taxpayers, promoters, and tax schemes involved in sheltering income. We have reason to believe that you may have participated in a potentially abusive tax shelter to avoid paying income tax. Participating in abusive tax shelters exposes you to substantial risks of increased penalties and interest. However, you can save money by taking advantage of the Voluntary Compliance Initiative (a one-time offer to avoid these penalties). To participate, you must complete three simple steps by **April 15, 2004**:

1. Complete an amended return and Voluntary Compliance Participation Agreement Form,
2. Pay the taxes and interest,
3. Mail the tax forms and payment (except for EFT payments) to: **VCI, Franchise Tax Board, PO Box 1673, Sacramento, CA 95812-1673**

New California law provides substantial penalties ranging from 20 percent to 75 percent of the underpayment and a penalty equal to 100 percent of the interest charged on any deficiency assessment. The law allows the Franchise Tax Board eight years (instead of only four years) to issue deficiency assessments on tax shelters.

You can participate in the Voluntary Compliance Initiative for tax years 2002 and prior. To obtain more information about this one-time offer, you can:

- Read the enclosed brochure.
- Visit our Voluntary Compliance Initiative Website at **www.ftb.ca.gov**.
- Email us at vci@ftb.ca.gov.
- Call our Voluntary Compliance Initiative hotline at (916) 845-3232, Monday – Friday, 9:00 a.m. to 4:00 p.m. (PST).

This letter constitutes formal notification of the Voluntary Compliance Initiative pursuant to California Revenue and Taxation Code Section 19751(e). If you do not participate in this initiative, you cannot avoid the abusive tax shelter and transaction penalties by filing an amended return after April 15, 2004.

Winston Mah, Chief
Audit Division
Enc. VCI Brochure and Participation Agreement Form

New California law authorizes the Franchise Tax Board to aggressively combat the use of abusive tax shelters and transactions by adding new registration and reporting requirements for promoters and organizers of potentially abusive tax shelters. As a tax professional, these new Registration and List of Investors Requirements apply to you if you:

- Participated in the organization of a potentially abusive tax shelter.
- Advised a potentially abusive tax shelter.-
- Provided an opinion on a potentially abusive tax shelter.
- Promoted a potentially abusive tax shelter.-
- Sold a potentially abusive tax shelter.
- Managed a potentially abusive tax shelter.

Your responsibilities to report, register, and maintain investor lists for potentially abusive tax shelters are described below. You can get detailed information by clicking on the respective links shown below.

Registration Requirements

Beginning January 1, 2004, if you participate in one of the above noted activities, you must register California related¹ tax shelters with the Franchise Tax Board by the first day the tax shelter interests are offered for sale. Additionally, by **April 30, 2004**, you must register California related tax shelters with the Franchise Tax Board if your clients invested in any transaction:

- after February 27, 2000 that became a federal listed transaction at any time, or
- after September 1, 2003 that became a California listed transaction at any time.

List of Investors Requirements

If you must maintain a list of investors for federal purposes, you must now maintain a list of investors in California related tax shelters or transactions for the Franchise Tax Board. Generally, you must provide this list to the Franchise Tax Board upon request. However, by **April 30, 2004**², you must provide investor lists to the Franchise Tax Board if your client invested in any transaction:

- after February 27, 2000 that became a federal listed transaction at any time, or
- after September 1, 2003 that became a California listed transaction at any time.

Penalties

If you do not comply with these provisions, you may be subject to substantial penalties including:

Failure to Register Tax Shelter	\$15,000
Failure to Register Listed Transaction (greater of)	\$100,000 or 50% of gross income
Intentional Disregard to Register Listed Transaction (greater of)	\$100,000 or 75% of gross income
Failure to Maintain/Provide Investor List for Reportable Transactions	\$10,000 per day
Failure to Provide Investor List for Listed Transactions (greater of)	\$100,000 or 50% of gross income
Promoter penalty	50% of gross income
Preparer penalty	\$1,000 per return
Preparer penalty - Willful or Reckless Conduct	\$5,000 per return

You can also find more information about the new tax shelter provisions and [Voluntary Compliance Initiative](#) program on our website, or by calling us at (916) 845-3232.

¹ California related tax shelters include those that are organized in California, do business in California, derive income from California sources, or have at least one California investor.

² After April 30, 2004, you must provide this information by the later of 60 days after (1) the investors enter the transaction, or (2) the transaction becomes listed.

Appendix B.7. VCI Charts and Graphs of Statistics

The charts and graphs on the following pages illustrate the results of the VCI. The type of taxpayer or the option selected generally categorizes the data. This cover page further explains the terminology used within the charts and graphs.

Taxpayers:

Taxpayers were analyzed based on whether they were a part of Personal Income Tax (PIT) revenues or Corporate Tax (Corp) revenues.

1. PIT data includes individuals and trusts.
2. Corp data includes all business entities.

Options:

Taxpayers had to elect one of two binding options when they participated in the VCI. They made this selection on the Participation Agreement. (see appendices B.1 and B.2.)

1. A taxpayer electing Option 1 waived their right to appeal the amounts they reported in the VCI.
2. A taxpayer electing Option 2 maintained their rights to dispute the amounts reported for the VCI. To further clarify the taxpayer's action under Option 2, FTB provided three subcategories for the taxpayer to elect to expedite handling. These subcategories were:
 - Option 2A-Treat VCI amended return as a claim for refund.
 - Option 2B-Taxpayer is not currently filing a claim for refund, but maintains right to file claim within statute of limitations.
 - Option 2C-Treat VCI amended return as a claim for refund that is pending a final federal determination.

These options appear in the various charts and graphs with the following labels:

Option	Label/Description	Comments
Option 1	Loses Appeal Rights	Taxpayer has NO appeal rights for amounts paid in connection with the tax shelter.
Option 2A	Filed Refund Claim	Taxpayer treats VCI election as a tax shelter claim for refund. Case remains open until claim is resolved.
Option 2B	Retains Appeal Rights	Taxpayer reserves the right to file a claim in the future. Case remains closed until taxpayer files a claim for refund
Option 2C	Awaiting Federal Action	Taxpayer has a federal action pending. Case remains open until federal determination is final.

List of Charts and Graphs that follow:

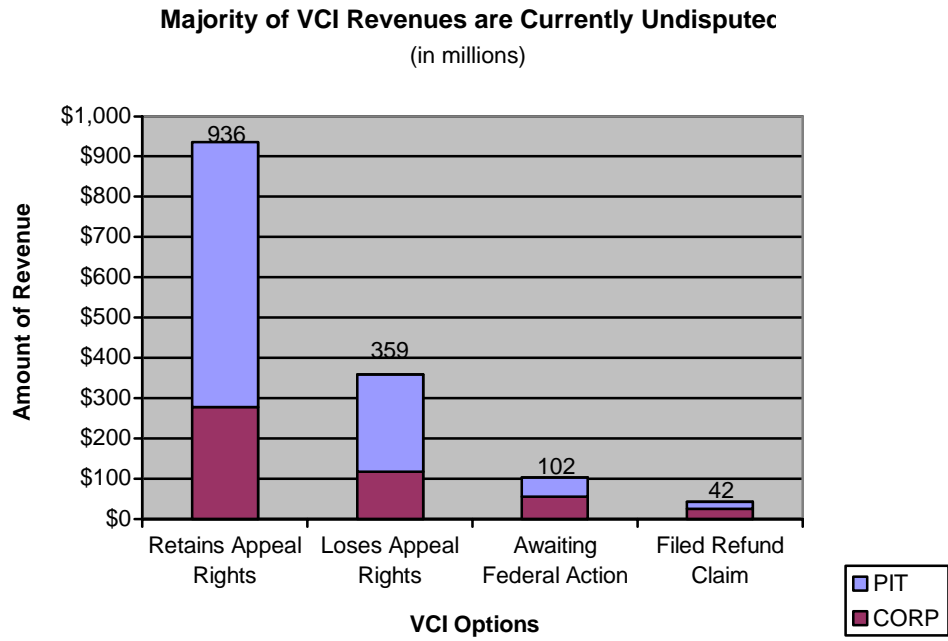
Appendix B.7.1	Summary of VCI by Options- Chart
Appendix B.7.2	Summary of VCI Revenues by Options- Graph
Appendix B.7.3	Summary of VCI Taxpayers by Options- Graph
Appendix B.7.4	VCI Returns by Tax Year- Graph and Table
Appendix B.7.5	Analysis of VCI by Taxpayer Type
Appendix B.7.6	Summary of VCI Participation by States
Appendix B.7.7.	Summary of VCI Participation by Taxpayer Type
Appendix B.7.8.	Illustration of Tax Shelter Penalties before and after 2003 legislation

Appendix B.7.1: Summary of VCI by Options

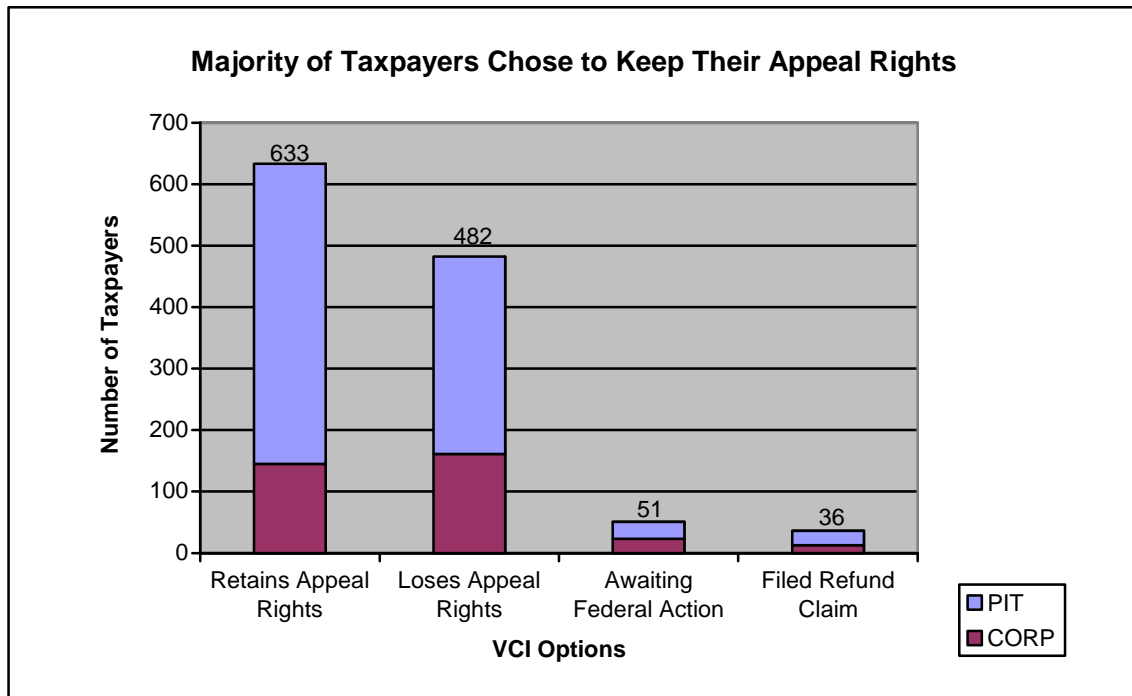
The chart below gives detail information regarding the number of taxpayers and the revenues associated with each type of Option elected.

Option	Option Description	PIT		CORP		TOTAL	
		T/P	Amount (in millions)	T/P	Amount (in millions)	T/P	Amount (in millions)
2B	Retains Appeal Rights	488	\$658	145	\$278	633	\$936
1	Loses Appeal Rights	321	\$242	161	\$117	482	\$359
2C	Awaiting Federal Action	28	\$55	23	\$47	51	\$102
2A	Filed Refund Claim	23	\$18	13	\$24	36	\$42
	TOTAL	860	\$973	342	\$466	1,202	\$1,439

Appendix B.7.2: Summary of VCI Revenues by Option

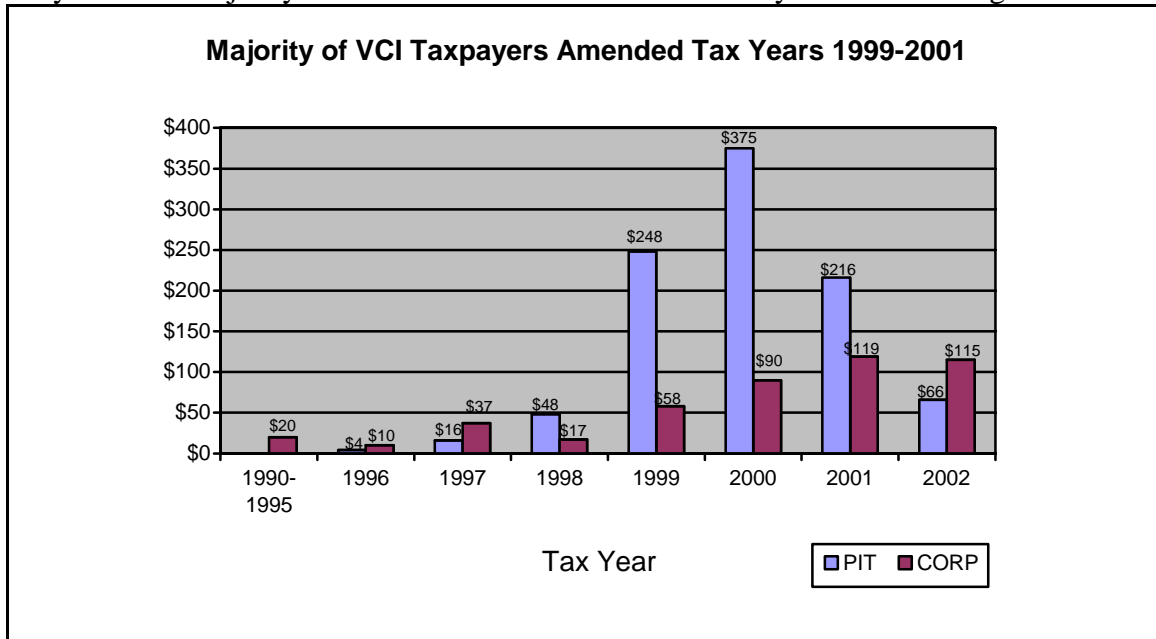


Appendix B.7.3. Summary of VCI Taxpayers by Option



Appendix B.7.4. VCI Returns by Tax Year

Taxpayers were able to amend any tax year for the VCI as long as the tax year preceded the 2003 tax year. The majority of the corrected returns were for tax years 1999 through 2001.



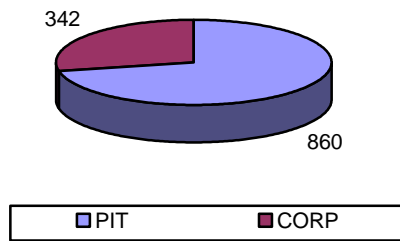
Details of VCI Returns by Tax Years

	PIT	CORP	TOTAL
Years	Amount (in thousands)	Amount (in thousands)	Amount (in thousands)
1990		\$2,138	\$2,138
1991		\$53	\$53
1992		(\$239)	(\$239)
1993		\$403	\$403
1994		\$9,078	\$9,078
1995		\$8,236	\$8,236
1996	\$3,728	\$10,560	\$14,288
1997	\$15,703	\$36,647	\$52,350
1998	\$48,368	\$16,806	\$65,174
1999	\$248,058	\$58,076	\$306,134
2000	\$375,254	\$90,293	\$465,547
2001	\$216,208	\$118,990	\$335,198
2002	\$65,990	\$114,844	\$180,834
TOTAL	\$973,309	\$465,885	\$1,439,194

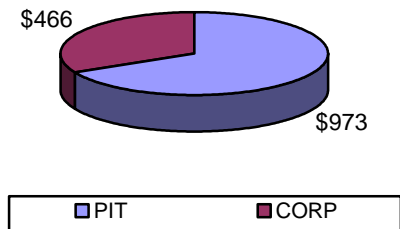
Appendix B.7.5. Analysis of VCI by Taxpayer Type

Individuals were the main taxpayers taking advantage of the VCI and reporting the most in additional tax.

VCI Participation by Taxpayer Type



VCI Revenues by Taxpayer Type



Appendix B.7.6: Summary of VCI Participation by States

While the majority of the VCI returns included California addresses, over \$300 million in VCI revenues were attributable to VCI returns filed with addresses from forty states other than California.

STATE/ AREA	PIT	CORP	TOTAL
	Amount (in thousands)	Amount (in thousands)	Amount (in thousands)
Alabama	\$443	\$527	\$970
Arkansas		\$15,830	\$15,830
Arizona	\$463	\$7,664	\$8,127
California	\$895,032	\$210,063	\$1,105,095
Colorado	\$4,155		\$4,155
Connecticut	\$41		\$41
District of Columbia	\$667		\$667
Delaware		\$1,882	\$1,882
Florida	\$12,047	\$3,401	\$15,448
Georgia	\$348	\$11,731	\$12,079
Hawaii	\$4		\$4
Iowa		\$60	\$60
Indiana	\$5		\$5
Illinois	\$702	\$36,473	\$37,175
Indiana		\$0	\$0
Kansas		-\$21	-\$21
Louisiana	\$14		\$14
Massachusetts	\$5	\$2,957	\$2,962
Maryland	\$7	\$19	\$26
Michigan	\$432	\$21,897	\$22,329
Minnesota	\$93	\$61,657	\$61,750
Missouri	\$13	\$6,748	\$6,761
Mississippi	-\$13	\$3	-\$10
Montana	\$920		\$920
North Carolina	\$21	\$45,640	\$45,661
Nebraska			
New Hampshire	\$9		\$9
New Jersey	\$4,307	\$1,198	\$5,505
Nevada	\$36,611		\$36,611
New York	\$3,741	\$8,457	\$12,198
Ohio	\$2	\$2,954	\$2,956
Oklahoma	\$5		\$5
Oregon		\$112	\$112
Pennsylvania	\$4,330	\$438	\$4,768
Rhode Island		\$1,883	\$1,883
Tennessee	\$50	\$1,694	\$1,744
Texas	\$6,676	\$8,364	\$15,040
Utah	\$302	\$13,256	\$13,558
Virginia	\$106	-\$54	\$52
Washington	\$1,412	\$566	\$1,978
Wisconsin		\$486	\$486
Canada/UK	\$359		\$359
TOTALS	\$973,309	\$465,885	\$1,439,194

Appendix B.7.7: Summary of VCI Participation by Taxpayer Type

The following tables provide additional data regarding how each type of taxpayer participated in the VCI. The tables display the data by option elected and indicate how many taxpayers (TP) and tax years (TY) participated for each taxpayer type.

- Individuals and Estates & Trusts information is included in the Personal Income Tax data.
- Corporations, Partnerships, and Limited Liability Company information is included in the Business Entities data.

	TOTAL				PIT			Business Entities		
	TP	TY	Amount		TP	TY	Amount	TP	TY	Amount
Option 1	482	904	\$359,354,527		321	565	\$242,350,395	161	339	\$117,004,132
Option 2A	36	80	\$42,233,130		23	55	\$18,455,390	13	25	\$23,777,740
Option 2B	633	1,192	\$936,064,371		488	847	\$657,707,648	145	345	\$278,356,723
Option 2C	51	113	\$101,542,108		28	54	\$54,795,295	23	59	\$46,746,813
TOTAL	1,202	2,289	\$1,439,194,137		860	1,521	\$973,308,728	342	768	\$465,885,408

	Individuals			Estates & Trusts			Corporation			Partnerships			Limited Liability Co.		
	TP	TY	Amount	TP	TY	Amount	TP	TY	Amount	TP	TY	Amount	TP	TY	Amount
Option 1	288	486	\$223,095,277	33	79	\$19,255,117	128	293	\$116,945,852	20	24	\$17,737	13	22	\$40,543
Option 2A	23	55	\$18,455,390	0	0	\$0	13	25	\$23,777,740	0	0	\$0	0	0	\$0
Option 2B	467	819	\$649,863,123	21	28	\$7,844,525	130	323	\$278,352,895	9	13	\$0	6	9	\$3,828
Option 2C	26	50	\$46,168,876	2	4	\$8,626,419	20	56	\$46,746,013	0	0	\$0	3	3	\$800
TOTAL	804	1,410	\$937,582,667	56	111	\$35,726,062	291	697	\$465,822,500	29	37	\$17,737	22	34	\$45,171

Appendix B.7.8:

Illustration of Tax Shelter Penalties before and after California's 2003 Legislation¹

Penalty or Action	Before	After
Failure to Disclose a Reportable Transaction Penalty	N/A	<ul style="list-style-type: none"> ▪ \$15,000 ▪ \$30,000 if a listed transaction
Accuracy Related Penalty	20%-40% of understatement	20%-40% of understatement <ul style="list-style-type: none"> ▪ Lower threshold for corporations with substantial understatements
Noneconomic Substance Transaction Understatement Penalty	N/A	<ul style="list-style-type: none"> ▪ 20% if disclosed ▪ 40% if not disclosed
Reportable Transaction Understatement Penalty	N/A	<ul style="list-style-type: none"> ▪ 20% if transaction disclosed ▪ 40% if not disclosed
Failure to Register Penalty	\$1,000 per investor	<ul style="list-style-type: none"> ▪ \$15,000 per organizer, plus > of \$100,000 or 50% of gross income ▪ 50% or 75% if intentional disregard
Failure to Maintain Investor List Penalty	N/A	\$10,000 a day
Preparer Penalty	<ul style="list-style-type: none"> ▪ \$250 ▪ \$1,000 willful or reckless conduct 	<ul style="list-style-type: none"> ▪ \$1,000 ▪ \$5,000 willful or reckless conduct
Promoter Penalty	Lesser of \$1,000 or 100% of gross income	50% of gross income
Frivolous Tax Returns	\$500	\$5,000
Frivolous Submissions	N/A	\$5,000
Interest Based Penalty	N/A	100% of interest
Increased Interest Rate for qualified amended returns	N/A	150% of interest
Statute of Limitations	4 Years	8 Years
Subpoenas	FTB Three-member Board Approval	FTB Executive Officer Approval

¹ The 2003 Legislation referred to is Senate Bill 614 and Assembly Bill 1016.

CONTROLLER STEVE WESTLY

STATE OF CALIFORNIA

300 Capitol Mall
Sacramento, CA 95814
916.445.2636
www.controller.ca.gov

FOR IMMEDIATE RELEASE:
JUNE 10, 2004

CONTACT: PAUL HEFNER
916-324-2356

Westly Tax Cheat Crackdown Shrinks Budget Gap

Franchise Tax Board Expects to Collect \$92 million in Taxes Owed but Unpaid

SACRAMENTO – State Controller Steve Westly today announced plans to collect \$92 million in unpaid taxes by cracking down on withholding fraud and expanding efforts to track phony tax shelters.

In his role as chair of the Franchise Tax Board, Westly called for the Board to improve auditing methods, reinstate programs to identify people attempting to hide their income through improper withholding and continue working to curb use of abusive tax shelters.

“The first step in closing the budget gap should be collecting the taxes already on the books,” Westly said. “Before we raise taxes or cut vital services, let’s make sure everyone is paying their fair share.”

Westly’s proposals, which were to be discussed by the Board today, could help offset many of the proposed budget cuts to California colleges and universities.

The steps to be considered by the FTB include:

- **Reinstate Questionable Wage Withholding Program**

Westly has proposed restarting a program last operated in 1999 to identify taxpayers who under-withhold their taxes by claiming excessive dependents (more than 10) or claiming exempt status. *Estimated accelerated revenue: \$30 million*

- **Establish Abusive Tax Shelter Strike Force**

To build on recent successes in cracking down on abusive tax shelters, Westly called on the FTB to create a special tax shelter strike force to collect and analyze information about abusive tax shelters; identify organizers, promoters, and participants in abusive tax shelters; and share information with federal, state, and in some cases foreign, tax authorities. Funding for the strike force is included in the proposed May budget revision for the 2004-2005 fiscal year. *Estimated revenue: \$56 million*

- **Improve FTB Auditing and Increase Penalties for Tax Cheats**

FTB will utilize new audit modeling techniques and information sources to identify non-filers and underreported income. In addition, FTB will implement additional enforcement for filing false returns or failure to pay taxes, file returns, or provide required information. *Estimated revenue: \$5.9 million*

Westly also called on the Legislature to consider a number of new steps to reduce tax fraud, including proposals to identify taxpayers and corporations failing to file returns, create a reward program for informants who report tax violations and to bar unscrupulous tax practitioners from doing business.

Controller Westly's new package seeks to build on the success of California's Voluntary Compliance Initiative, created through legislation by Assembly Majority Leader Dario Frommer, Senator Gil Cedillo and Senate President pro Tem John Burton.

The initiative gave taxpayers who used abusive tax shelters a one-time chance to amend their returns before increased penalties took effect. The effort was projected to collect \$90 million, but actually brought in \$1.325 billion.

Westly is also co-sponsor of legislation to provide a two-month tax amnesty. The bill, AB 2203 by Assemblymember Judy Chu, would increase penalties and interest rates on unpaid tax liabilities at the end of the amnesty period. The new program is expected to raise \$300 million.

###

CONTROLLER STEVE WESTLY

STATE OF CALIFORNIA

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FOR IMMEDIATE RELEASE:
APRIL 22, 2004

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916-445-2636

Westly Announces \$838 Million Windfall Will Help Budget Deficit

Tax Amnesty Campaign Far Exceeds Expectations

Sacramento, CA – State Controller and Franchise Tax Board Chair Steve Westly today announced that California's tax amnesty program has collected nearly 10 times the expected amount, bringing \$838 million to the state's coffers. The program was projected to generate \$90 million.

"The huge success of our amnesty program shows that government can think outside the box. We must collect the taxes already owed to California before we consider raising taxes or cutting services," Westly said. "Among all the bad budget news, this is a bright spot because this extra money may help spare a clinic or a senior center from the budget axe."

Westly supported legislation signed in 2003 (SB 614, Cedillo & Burton; AB 1601, Frommer) that added enforcement tools and stiffer penalties to target illegal tax shelters. The new law also created the Voluntary Compliance Initiative, a one-time chance for taxpayers who used abusive tax shelters to come forward and amend their state tax returns before increased penalties took effect. The program ended on April 15, 2004.

To date, 460 individual taxpayers have brought in \$589 million and 182 corporate taxpayers have brought in \$249 million. The FTB is still totaling Voluntary Compliance Initiative receipts, and will announce the final number in early May.

"In light of our budget deficit, this news couldn't have come at a better time," Westly added.

###

State to Serve First of Tax Shelter Subpoenas

With less than one week to go for taxpayers to take advantage of the relief program for abusive tax shelters, state tax lawyers today are serving subpoenas to two major insurance companies who may have insured certain abusive tax shelters against government enforcement actions, announced the Franchise Tax Board (FTB).

This action serves as a turning point as the FTB transitions into its enforcement phase to curtail abusive tax shelters. Abusive tax shelters are transactions marketed with the promise of tax benefits with no correlating economic losses.

The subpoenas are demanding names and addresses of all California residents, persons with mailing addresses in California, and businesses doing business in California who were issued insurance policies or who sought to procure policies for tax liability, fiscal event, tax indemnity, or any similar product from 1999 through 2002.

The FTB's subpoenas require the insurance companies to provide documents pertaining to the marketing, sales, and issuance of these tax liability insurance policies, particularly as they may relate to the proliferation of abusive tax shelters.

For taxpayers who have invested in abusive tax shelters, the state is administering a Voluntary Compliance Initiative that runs through April 15. The Voluntary Compliance Initiative is a one-time chance for taxpayers who used abusive tax shelters to come forward and amend their state tax returns before the state starts pursuing the harsher penalties authorized by legislation signed last year (SB 614, Cedillo & Burton; AB 1601, Frommer). To date, this effort has collected \$167 million from participating taxpayers.

The FTB is leading an aggressive effort to combat abusive tax shelters that are estimated to cost the state from \$600 million to more than \$1 billion annually. The new anti-shelter law provides the FTB with more enforcement tools to curtail the use of abusive tax shelters. Besides increasing the time period to conduct audits and greater registration requirements, the new law greatly increases penalties for both investing in and promoting illegal tax shelters.

Interested taxpayers have until April 15, 2004, to amend their returns and fully pay the tax and interest due. To learn more about the FTB's Voluntary Compliance Initiative, visit our Website at www.ftb.ca.gov.

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Last Modified Date: 07/21/2004

States Sign Anti-Abusive Tax Shelter Agreement

Tax agencies in 34 states plus New York City today signed a joint agreement to share information among themselves on abusive tax shelters and illegal transactions, a move intended to strengthen their fight against this complex problem.

The document signed today focuses on the type of abusive tax transaction information to be shared, confirms the role of joint promoter audits and coordinated enforcement actions, and encourages active exchanges of case listings and documents.

California State Controller and Chair of the Franchise Tax Board Steve Westly added, "With California facing a record budget deficit, we can't afford to let tax cheats take money away from schools, healthcare, and major projects like building freeways. We're teaming up with other states to work smarter, catch more tax cheats, and collect the revenue they owe."

"Abusive tax avoidance transactions have become a threat to the fiscal health of our states," explained Stephen M. Cordi, Deputy Comptroller for Maryland and president of the Federation of Tax Administrators (FTA), an association of the tax agencies in all states, Washington, D.C., and New York City. "It's hard to overstate the size of the problem, or the difficulty of dealing with it in an efficient and systematic way."

"These schemes depend on dozens of layers of transactions – each one intended to bury the taxable income a little deeper. The layers are then scattered among any number of states. We can only uncover these types of schemes by sharing knowledge and by having a close working relationship with our sister states."

As New York State Department of Taxation and Finance Commissioner Andrew S. Eristoff explained, "Working with the IRS and other states, we will scrutinize major accounting firms, tax practitioners, and other professional firms who may be or have been involved in promoting these illegal schemes, which allow companies and individuals to evade millions of dollars in taxes. The complexity of these transactions doesn't mitigate the fact that these companies and individuals are engaged in potentially criminal acts, ripping off the vast majority of honest taxpayers."

State tax agencies routinely share confidential tax data with one another. For more than 10 years FTA has facilitated this activity by developing and sponsoring the Uniform Exchange of Information Agreement. Each state's statute spells out the manner in which confidential data must be shared, stored, and disposed of. The multistate disclosure agreement is the written authorization required by each state's statute. Today's agreement specifies the types of work that will be done together to combat abusive and illegal transactions.

The new agreement complements one signed last September between the IRS and 45 states, Washington, D.C., and New York City. Under the terms of the Abusive Tax Avoidance Transactions (ATAT) partnership, the federal and state governments agreed to coordinate their efforts and share data on illegal schemes that evade both federal and state taxes.

However, there are abusive shelters and illegal transactions that are engineered to avoid state taxation only, particularly those involving the taxation of corporations, partnerships, and pass-through entities. Today's agreement provides a formal structure for the states to notify one another when they uncover one of these new schemes, to share insights on new compliance thinking, and to point out potentially fruitful directions for audit exploration.

The states that signed today's Memorandum of Agreement are as follows. More states are expected to sign in the coming weeks.

1. Alabama	13. Kansas	25. Oklahoma
2. Arizona	14. Louisiana	26. Pennsylvania
3. Arkansas	15. Maine	27. Rhode Island
4. California	16. Minnesota	28. South Carolina
5. Colorado	17. Missouri	29. Tennessee
6. Connecticut	18. Nebraska	30. Utah
7. Delaware	19. New Jersey	31. Vermont
8. Hawaii	20. New Mexico	32. Virginia
9. Idaho	21. New York City	33. Washington
10. Illinois	22. New York State	34. West Virginia
11. Indiana	23. North Carolina	35. Wisconsin
12. Iowa	24. Ohio	

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Last Modified Date: 07/21/2004

Memorandum of Understanding

Memorandum of Understanding Between Internal Revenue Service Small Business/Self-Employed Division (SB/SE) and [State tax agency] Concerning Abusive Tax Avoidance Transactions

1. INTRODUCTION:

This Memorandum of Understanding (MOU) between the Internal Revenue Service (IRS) Small Business/Self-Employed Division (SB/SE) and the **[state tax agency name (state tax agency abbreviation)]** sets forth the agreement of the parties with respect to an initiative to facilitate information sharing for tax administration purposes in conjunction with Abusive Tax Avoidance Transactions (ATAT).

2. AUTHORITY:

A. Under the terms of this MOU, federal tax returns and return information related to ATAT will be disclosed by the IRS to **[state tax agency]** pursuant to Internal Revenue Code (IRC) section 6103(d). This MOU is intended to facilitate information sharing between the IRS and **[state tax agency]** pursuant to the existing Agreement on Coordination of Tax Administration between the IRS and **[state tax agency]** (herewith "Basic Agreement") executed by IRS on **[date]**, and the Amended Implementing Agreement on Coordination of Tax Administration between the IRS and **[state tax agency]** (herewith "Amended Implementing Agreement") executed by the IRS on **[date]**. The Basic Agreement, the Amended Implementing Agreement, and this MOU constitute the written request required under IRC 6103(d) for the disclosure of federal returns and return information related to ATAT from the IRS to the **[state tax agency]**. The **[state tax agency]** will use the information to be disclosed to identify, examine, and bring participants in ATAT into compliance with **[state]** tax laws. The **[state tax agency]** agrees that it will only use the information for purposes of state tax administration pursuant to IRC 6103(d) and the Basic Agreement, the Amended Implementing Agreement, and this MOU. In any situation where a conflict arises between the provisions of this MOU and the Basic and Implementing Agreements, the Agreements shall govern.

B. State returns and return information will be disclosed to IRS pursuant to **[state statute]**. The information will be used by the IRS to identify, examine, and bring ATAT participants into compliance with federal tax laws and regulations.

3. PURPOSE:

A. This sharing of ATAT-related information will present a united compliance front to taxpayers and their representatives, increase audit coverage, and leverage federal and state resources in the ATAT area.

B. This MOU also serves to facilitate communication between IRS and **[state tax agency]** and the disclosure of returns and return information between IRS and **[state tax agency]** employees who deal with ATAT leads, cases, and audits.

4. PARTIES TO AGREEMENT:

A. Parties that will share tax returns and return information include IRS and **[state tax agency]**. IRS and **[state tax agency]** employees authorized to request and receive tax information will be designated in writing pursuant to Article **[number]** of the Amended Implementing Agreement.

B. The SB/SE Compliance Area Director (working with the Headquarters, ATAT Program Office) and the **[head of state tax agency]**, will designate, in writing, the names of IRS and state employees who will be authorized to request and receive ATAT-related tax information pursuant to this MOU. The names, telephone numbers, and addresses of these IRS and **[state agency]** employees will be attached to this MOU as an addendum within 30 calendar days of execution of this agreement. A copy of this list will be provided to the IRS Disclosure Officer. This list will be updated annually, or as needed, by the SB/SE Compliance Area Director, and headquarters, ATAT Program Office, and by the **[head of state tax agency]**. A copy of the amended list will be provided to the IRS Disclosure Officer. Amendments to the list of IRS employees authorized to request and receive tax information may be made at any time by written notification from the IRS SB/SE Compliance Area Director (working with headquarters, ATAT Program Office) to the **[head of the state agency]**. Amendments to the list of **[state agency]** employees may be made at any time by written notification from the **[head of the state agency]** to the IRS SB/SE Compliance Area Director.

C. IRS and **[state agency]** employees who are named on the list described above will be authorized to request and receive tax information pursuant to the Basic Agreement, the Amended Implementing Agreement, and this MOU for the duration of their designation on the list, their participation in this cooperative effort related to ATAT, and based on their "need to know" the information as best serves effective tax administration.

5. CONTACTS:

Contacts for the purpose of this MOU will be the IRS SB/SE designee, the IRS Governmental Liaison for **[state]**, the IRS Disclosure Officer, and the **[state tax agency]** Disclosure Officer designee (see attached contact list).

6. JOINT OUTREACH:

The IRS and **[state tax agency]** will coordinate outreach activities relating to ATAT issues as appropriate. This may include, but is not limited to, joint press releases, joint dissemination of counter-marketing messages, joint publicity of ATAT initiatives, and other outreach materials.

7. DUTIES AND RESPONSIBILITIES OF THE IRS:

- A. To avoid duplication of efforts, the IRS SB/SE Headquarters, ATAT Program Office will provide to **[state tax agency]** a list of participants in a particular ATAT scheme that may be investigated by the State. The list will be provided after the participants in a particular scheme are identified and the IRS determines a compliance strategy for the promotion. This list will be updated semi-annually on or about July 31 and January 31 and provided to **[state tax agency]**.
- B. The IRS will provide to **[state tax agency]** all audit results from ATAT participant cases conducted by the IRS.
- C. The IRS will exchange information on types of ATAT schemes identified at the federal level with **[state tax agency]**.
- D. The IRS will provide audit technique guides, when available, for ATAT schemes to **[state tax agency]**.
- E. IRS employees who request state returns or return information should complete Form 8796, "Request for Return/Information."
- F. Form 8796, "Request for Return/Information" to request state information or Form 10475, "State Tax Information Request" will be signed and approved by the SB/SE Compliance Territory Manager.
- G. All requests from authorized IRS employees for state information should be forwarded to the **[state title & address]** for response.
- H. The IRS will partner with **[state tax agency]** on training and other educational activities. The IRS will provide **[state tax agency]** with opportunities to attend ATAT training classes or use IRS instructors.
- I. The IRS may initiate communications on an as needed basis to facilitate the purposes of

this MOU.

8. DUTIES AND RESPONSIBILITIES OF [STATE TAX AGENCY]:

- A. After receipt of a participant list from the IRS, **[state tax agency]** will provide IRS a list of those participants, **[state tax agency]** intends to examine.
- B. States will assist IRS in utilizing State databases to further refine participant lists.
- C. Upon completion of state examinations and state assessments of ATAT cases, the **[state tax agency]** will forward the results to the IRS SB/SE Chief, Planning and Special Programs.
- D. **[State tax agency]** will provide information on types of ATAT schemes identified at the state level to the IRS.
- E. **[State tax agency]** will exchange state audit strategies and procedures regarding ATAT with the IRS.
- F. **[State tax agency]** employees who request federal returns or return information should normally complete Form 8796, "Request for Return/Information."
- G. Requests from **[state tax agency]** employees for federal ATAT information should be forwarded to the IRS Disclosure Officer.
- H. **[State tax agency]** will partner with IRS on training and other educational activities. **[State tax agency]** will provide IRS with opportunities to attend ATAT training classes or use **[state tax agency]** instructors.
- I. Where appropriate, **[state tax agency]** will have members on the IRS cross-functional ATAT council.
- J. **[State tax agency]** may initiate communications on an as needed basis to facilitate the purposes of this MOU.

9. DISCLOSURE, SAFEGUARDS, AND RECORD KEEPING REQUIREMENTS:

- A. The IRS Disclosure Officer will ensure that all requirements for recordkeeping and accounting for disclosures are met in accordance with IRC section 6103 and its implementing regulations.
- B. In order to comply with the federal safeguards required by IRC section 6103(p)(4), **[state tax agency]** employees will maintain federal tax returns and return information separately, in addition to abiding by the procedures implementing IRC section 6103(p)(4).
- C. IRS employees will maintain state information separately. All records and documents collected, maintained, or generated by the IRS and/or disclosed to **[state tax agency]** under this MOU, and any information collected as a result of joint correspondence, joint interviews, or IRS administrative summonses, will be subject to the confidentiality requirements of IRC section 6103(a).
- D. All information obtained under this Agreement must be safeguarded in accordance with the **[date]** Agreement on Coordination of Tax Administration (herewith "Basic Agreement"), any revisions, and the Amended Implementing Agreement as well as the safeguards described in IRS Publication 1075, *Tax Information Security Guidelines for Federal, State, and Local Agencies*.
- E. Nothing in this Agreement will cause IRS or **[state tax agency]** to disclose information that is normally protected by governmental, attorney/client, or attorney work product privileges consistent with applicable laws, or any other information that is prohibited from disclosure. See IRM Section 11.3.32.17, Restrictions on disclosure of returns and return information.
- F. Neither the IRS nor **[state tax agency]** will disclose return information that would identify a confidential informant or seriously impair any civil or criminal tax investigation. Voluntary disclosures to the IRS under the guidance of Internal Revenue Code (IRC) 6011 will not be included in the participants lists provided to the states. States will receive final assessments related to IRC 6011 voluntary disclosures through established channels.

10. LIABILITY:

- A. Each party to this Agreement shall be liable for the acts and omissions of its own

employees.

B. The IRS shall not be liable for any injury to another party's personnel or damage to another party's property unless such injury or damage is compensable under the Federal Tort Claims Act, 28 U.S.C. § 1346(b), or pursuant to other federal statutory authority.

C. **[State tax agency]** shall not be liable for any injury to another party's personnel or damage to another party's property unless such injury or damage is compensable under the law of the state of **[state]**.

11. THIRD PARTY RIGHTS:

This MOU does not confer any rights or benefits on any third party.

12. AMENDMENT OR TERMINATION OF MOU:

This MOU will become effective on the date of the last signature written below and will remain in force until terminated by either IRS or **[state tax agency]**. If the IRS or **[state tax agency]** wishes to terminate this MOU, a written notice must be mailed to, or otherwise delivered to, the other party. The MOU will terminate 30 calendar days after the receipt of such notice. This MOU may only be amended upon the mutual consent of the IRS and **[state tax agency]**. A written notice of the terms of the amendment must be mailed to, or otherwise delivered to, the other party.

13. LIMITATIONS:

The terms of this MOU are not intended to alter, amend, or rescind any provisions of Federal law. Any provision of this MOU, which conflicts with Federal law will be null and void. Nor are the terms of this MOU intended to alter, amend, or rescind any provisions of the Basic Agreement or the Amended Implementing Agreement now in effect. In the case of conflict, the provisions of the Basic Agreement and/or the Amended Implementing Agreement will govern.

APPROVALS:

[Name], Commissioner

[Name of State Tax Agency]

Signed at _____, this _____ day of _____, 2003.

[Name], Area Manager

Governmental Liaison and Disclosure
Internal Revenue Service

Signed at _____, this _____ day of _____, 2003.

[Name & title]

SB/SE Director of Compliance
Internal Revenue Service

Signed at _____ this _____ day of _____, 2003.

Memorandum of Agreement Pertaining to Abusive Tax Avoidance Transactions

Introduction

This Memorandum of Agreement (MOA) is entered into by and among the participating agencies through their duly authorized representatives pursuant to their respective statutes to facilitate tax administration in conjunction with abusive tax avoidance transactions (ATAT).

Purpose

The purpose of this MOA is to implement an information-sharing arrangement among the participating agencies. By coordinating audit programs and enforcement activities, participating agencies will be better equipped to mitigate the impact of abusive tax avoidance transactions on states' tax revenues. This coordinated effort will help identify those taxpayers, promoters, organizers and accommodators who participate in and promote ATAT.

Authority

This MOA incorporates the Federation of Tax Administrators Uniform Exchange of Information Agreement of January 1, 1993, pursuant to the respective authorities of the states and jurisdictions executing this agreement, as further described in Paragraph 6, under the Confidentiality section of this MOA below. In the event of a conflict between this MOA and the Uniform Exchange of Information Agreement, this MOA controls.

Information not subject to exchange

This MOA does not include, nor contemplate, the parties exchanging among themselves, information received from the Internal Revenue Service pursuant to Section 6103(d) of the Internal Revenue Code, unless the Internal Revenue Service explicitly authorizes the exchange. Unauthorized inspection or disclosure of Federal returns and other confidential federal return data is a felony (Sections 7213(a)(1) and 7213A(a)(1)(B) Internal Revenue Code).

Any information the disclosure of which would be in violation of, or detrimental to, the administration of the tax laws of any participating state is not subject to exchange. Each participating agency reserves the right to make the determination whether or not information is subject to exchange under the terms of this agreement.

Duties and Responsibilities

1. The participating agencies will provide to each other, upon request, a list of participants in identified ATAT schemes that are being investigated by the providing agency, together with such other information in the possession of the providing party, which could reasonably be considered useful to other parties for the investigation and identification of potential ATAT schemes. The lists and related information will be updated at least semiannually.
2. The participating agencies may request and exchange information concerning ATAT schemes at any stage of audit, administrative process, or any other form of inquiry or enforcement. The participating agencies intend that this MOA will promote timely sharing of information and efficient use of resources.
3. The participating agencies will exchange information regarding the types of ATAT schemes identified at the state level, including any promoter information and marketing strategies associated with those schemes.
4. The participating agencies will share audit techniques, strategies, procedures and guides developed for addressing ATAT schemes.
5. The participating agencies will conduct joint compliance activities where appropriate to avoid duplication of efforts and optimize use of resources.
6. The participating agencies will seek to develop a common information-sharing format and repository for ATAT information, to be maintained by one of the participating states. The submission of information for inclusion in the

repository shall constitute explicit consent to the disclosure of that information to the participating agencies, to remain in effect until the providing state indicates that the information shall be removed from the repository.

7. The participating agencies will assist each other in educational and promotional activities and make every effort to provide joint assistance in the ATAT endeavors, including compliance activities where appropriate.

General Provisions

1. INCORPORATION: This MOA incorporates the provisions, terms and definitions of the Federation of Tax Administrators Uniform Exchange of Information Agreement effective January 1, 1993, and as it may be amended.
2. CONTACT INFORMATION: Each participating state will designate a primary contact person who will be responsible for coordinating the requests for information between the states. Individual employees authorized to request and receive ATAT-related tax information pursuant to this MOA will be designated in accordance with the provisions of Article VI.2. of the FTA Uniform Exchange of Information Agreement, effective January 1, 1993, and as it may be amended.
3. TERM: This MOA is effective on the date it is executed by two or more states, and to additional states on the respective date(s) of execution. Duplicate signature pages and faxed signature copies are permitted. This MOA is not limited to a specific period of time and will be considered in effect until terminated.
4. AMENDMENTS: This MOA may not be amended other than by a writing duly executed by all the participating states.
5. SEVERABILITY: The terms and conditions of this MOA are intended to be valid and binding. In the event that any portion or portions of this MOA should, for any reason, be determined to be invalid or unenforceable, the remaining portions of the MOA shall continue to be valid and enforceable.

Confidentiality

1. Each participating state and its respective tax agency agrees that the taxpayer return information obtained under this MOA will be kept in the strictest confidence and shall make such information available to its own employees only on a "need to know" basis. Authorized employees and agents who have a need to know are those who need the information to perform their official duties. The parties recognize their mutual responsibilities to protect the confidentiality of taxpayer return information and hereby warrant that such information shall be disclosed only to those individuals and for such purposes as provided for in this agreement.
2. All records and documents constituting taxpayer return information collected, maintained or generated by the agencies or disclosed under this MOA and any other taxpayer return information collected as a result of joint correspondence, or joint interviews will be subject to the confidentiality requirements of the state receiving the information in question.
3. All information obtained under this MOA must be safeguarded in accordance with the requirements of the recipient agency.
4. Nothing in this MOA will permit the participating states to disclose information that is normally protected by governmental, attorney/client or attorney work product privileges consistent with applicable laws or any other information that is prohibited from disclosure.
5. The participating states are prohibited from disclosing information provided pursuant this MOA that would identify a confidential informant or seriously impair any civil or criminal tax investigation.
6. The current applicable statutory provisions of the state of each Signatory agency as they apply to the exchange of taxpayer return information, and the penalties for unlawful disclosure are maintained under Article V of the Uniform Exchange of Information Agreement by the primary clearinghouse (the Federation of Tax Administrators) and are incorporated into this agreement by reference.
7. Each participating state agrees to protect the confidentiality of all taxpayer return information obtained pursuant to this agreement in accordance with the laws of its state. No party shall disclose any information obtained pursuant to this MOA to any other agency, department or unit within the recipient state or to any local government unit,

except as otherwise provided in Article V of the Uniform Exchange of Information Agreement.

Safeguard and Record Keeping Requirements

1. **INFORMATION SECURITY:** Information security is defined as the preservation of the confidentiality, integrity, availability, authenticity and utility of information. A secure environment is required to protect the confidential information obtained pursuant to this agreement. All unauthorized disclosures of taxpayer return information obtained under the terms of this agreement will be reported immediately upon discovery to the contact person of the providing state. Appropriate tracking of access to information in the repository discussed above will be implemented.
2. **TRANSMISSION OF INFORMATION:** All information exchanged under this MOA will be transferred between the participating states in the most expedient and secure manner possible as determined by the providing participating state. Informal telephone inquiries regarding the availability of information for exchange are encouraged. Formal requests for information shall be in writing, or by verifiable electronic means, and must indicate the tax administration reason for the exchange if the reason is not apparent from the context of the request.
3. **DESTRUCTION OF RECORDS:** All records received by the participating states will be destroyed or returned to the providing state agency when they are no longer needed for the business purpose for which they were obtained. The records shall be destroyed in a manner reasonably calculated to ensure that the data is no longer usable, readable, or otherwise capable of being ascertained.

Definitions

ABUSIVE TAX AVOIDANCE TRANSACTIONS. The term "abusive tax avoidance transactions" means transactions promoted for the promise of tax benefits with no meaningful change in the taxpayer's economic position. These transactions typically have no economic purpose other than reducing taxes. Abusive tax avoidance transactions generally involve multiple ownership tiers and "cobwebs" of complex ownership structures.

TAXPAYER RETURN INFORMATION. The term "taxpayer return information" has the meaning ascribed to it in the Uniform Exchange of Information Agreement.

Ratification

See Attachment A.



25 Sigourney Street
Hartford CT 06106-5032

STATE OF CONNECTICUT
DEPARTMENT OF REVENUE SERVICES

AN 2004(5)

ANNOUNCEMENT

Abusive Tax Shelter Compliance Initiative

Purpose: This Announcement alerts taxpayers, accountants, lawyers, and financial professionals of a Connecticut Department of Revenue Services (DRS) compliance initiative for participants in abusive tax shelters.

Effective Date: June 16, 2004.

Background: In 2002, the United States Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs initiated an investigation into the development, marketing, and implementation of abusive tax shelters by professional organizations such as accounting firms, banks, investment advisors, and law firms. During the investigation, the Subcommittee issued numerous subpoenas and document requests, and the Subcommittee staff reviewed hundreds of thousands of pages of documents and conducted numerous interviews with representatives of professional organizations. The evidence reviewed by the Subcommittee establishes that the development and sale of potentially abusive and illegal tax shelters has become a lucrative business for professional organizations. The evidence also shows that some professional firms are spending substantial resources to design, market, and implement hundreds of complex tax shelters, some of which are illegal and improperly deny federal and state governments billions of dollars in tax revenues.

In light of this evidence, the Internal Revenue Service (IRS) and many state revenue departments have launched an aggressive campaign to shut down the use of abusive tax shelters where the shelters are designed, marketed, and undertaken solely to create tax benefits unintended by the tax laws. Congress has also introduced proposed legislation to severely punish promoters and participants in abusive tax shelters.

IRS Settlement Initiative: Over the past five years, the IRS has begun publishing notices identifying certain generic tax shelters as “potentially abusive” and warning taxpayers that the use of such “listed transactions” may lead to an audit and assessment of back taxes, interest, and penalties. “Potentially abusive” tax shelters are those that come within the scope of “listed transactions,” and “illegal shelters” are those with respect to which the IRS has taken actual enforcement action against taxpayers for violating federal law.

The IRS is currently offering a settlement initiative for the “listed transaction” entitled the “Son of Boss” (Bond Option Sales Strategy), where investors in such shelter have an opportunity to quickly close out their tax disputes. Under its terms, eligible taxpayers must apply to the IRS by June 21, 2004, and concede 100 percent of the claimed artificial tax losses created by false basis adjustments. In exchange for the concession, taxpayers will be allowed to treat as a loss their out-of-pocket transaction costs, such as promoter and professional fees, and eliminate or reduce penalties. *See IR-2004-64.*

DRS Compliance Initiative: DRS will be administering a compliance initiative through July 31, 2004, for all taxpayers that have participated in **any** “potentially abusive” tax shelter designated by the IRS as a “listed transaction.” For purposes of this Announcement, a “listed transaction” is a transaction that is the same as, or substantially similar to, one identified by the IRS under I.R.C. §6011 and the Treasury Regulations thereunder, whether or not (a) the IRS had identified the transaction as a “listed transaction” at the time the taxpayer entered into the transaction, or (b) the transaction is (or was) required to be disclosed by the taxpayer as a “listed transaction” according to the Treasury Regulations (including the temporary regulations) under I.R.C. §6011.

Terms of the Compliance Initiative:

- (1) Taxpayers must concede (a) 100 percent of the claimed artificial tax loss created by a false basis adjustment, or (b) any other gain mitigation strategy (such as S Corporation Tax Shelters (SC2s) or I.R.C. §401(k) Accelerators) used to shelter income. *See IRS Notice 2004-30; Rev. Rul. 2002-46.*
- (2) Interest on the underpayment of tax will be imposed until the taxpayer makes full payment of the liabilities. The filing of the election to participate described below does not suspend the accrual of interest on the underpayment.
- (3) Cost and fees associated with the establishment of an abusive tax shelter may be deducted for Connecticut tax purposes, to the extent they are allowed by the IRS.
- (4) In exchange for coming forward, DRS will not impose civil penalties and will not pursue criminal prosecution for the taxpayer's participation in a tax shelter.

Required Procedures:

- (1) **Participation Election.** Taxpayers participating in this initiative must notify DRS of their election by sending **Form CT-ATS, Election to Participate in the Connecticut Abusive Tax Shelter Compliance Initiative**, on or before **July 31, 2004** to:

**Department of Revenue Services
Abusive Tax Shelter Compliance Unit
Audit Division
25 Sigourney Street
Hartford, CT 06106**

- (2) **Additional Information.** Upon receipt and review of the notice to participate, DRS will mail a notice of acknowledgment to the taxpayer listing the documentation and additional information needed from the taxpayer. After receiving the notice of acknowledgment, the taxpayer must submit to DRS on or before September 30, 2004, all information and documentation relevant to the tax shelter and any additional information requested by the Audit Division. This information will allow DRS to calculate the additional taxes and interest due as a result of the taxpayer's participation in the

compliance initiative. DRS may grant additional time for this process if good cause is shown.

Closing Agreement and Payment: After receipt of the taxpayer's requested information and documentation, DRS will prepare a Closing Agreement under Conn. Gen. Stat. §12-2e reflecting the terms of the compliance initiative. The Closing Agreement will also provide that taxpayers may not file a claim for refund or receive a credit for the amounts paid (including interest) under the compliance initiative in connection with their participation in a "listed transaction." Additionally, taxpayers may not appeal any issue that relates to or may affect the amounts paid (including interest) under this compliance initiative in connection with their participation in a "listed transaction."

Subsequent to drafting the Closing Agreement, DRS will mail the document to the taxpayer. The taxpayer must sign the Closing Agreement and return it to DRS with full payment of liabilities within 30 days of the date of mailing by DRS. Once full payment is received, DRS will sign and execute the Closing Agreement and a copy of such agreement will be sent to the taxpayer. If full payment is not timely made to DRS, the taxpayer will be ineligible to participate in this compliance initiative. DRS may grant an extension of payment for good cause to taxpayers who request additional time within the 30 day period.

Enforcement: DRS will target and aggressively pursue any taxpayer that has engaged in a "listed transaction" to shelter income and that does not come forward to participate in this settlement initiative. DRS will impose the most severe penalties available under the law against such taxpayers.

To find participants in abusive tax shelters, DRS is methodically reviewing and examining the public subpoenaed information uncovered by the United States Senate Permanent Subcommittee on Investigations and is working in conjunction with the IRS to exchange information. Also, Connecticut is one of many states, including California and New York, to sign a joint agreement to share information on abusive tax shelters and illegal transactions. The agreement was facilitated by the Federation of Tax Administrators (FTA) and is intended to provide a formal structure for the states to cooperate with each other when a shelter is uncovered. Information between the states is already being shared.

Effect on Other Documents: None.

Effect of This Document: Announcements alert taxpayers to new developments (other than newly enacted or amended Connecticut or federal laws or newly released judicial decisions), including new administrative positions, policies, or practices.

For Further Information: Call DRS during business hours, Monday through Friday:

- **1-800-382-9463** (in-state), or
- **860-297-5962** (from anywhere)

TTY, TDD, and Text Telephone users only may transmit inquiries anytime by calling 860-297-4911.

Forms and Publications: Forms and publications are available anytime by:

- **Internet:** Preview and download forms and publications from the DRS Web site at **www.ct.gov/DRS**
 - **DRS TAX-FAX:** Call **860-297-5698** from the handset attached to your fax machine and select from the menu. (Only forms (not publications) are available on TAX-FAX.)
 - **Telephone:** Call **860-297-4753** (from anywhere), or **1-800-382-9463** (in-state) and select **Option 2** from a touch-tone phone.
-

Paperless Filing Methods (fast, easy, free, and confidential):

- **For business returns:** Use *Fast-File* to file sales and use taxes, business use tax, room occupancy tax, or withholding tax returns over the Internet or telephone. Visit the DRS Web site at **www.ct.gov/DRS** and click on *File Returns On-Line* or call **860-947-1988**.
 - **For resident income tax returns:** Use *WebFile* to file personal income tax returns over the Internet. Visit the DRS Web site at **www.ct.gov/DRS** and click on *File Returns On-Line*.
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Tax Shelter Voluntary Compliance Program

Informational Bulletin

August 2004

Brian A. Hamer
Director of Revenue

For information or forms...

- ◆ Call us at:
1 800 732-8866 or
217 782-3336
- ◆ Call our TDD
(telecommunications device
for the deaf) at:
1 800 544-5304
- ◆ Write us at:
Illinois Department of Revenue
P.O. Box 19044
Springfield, IL 62794-9044
- ◆ Visit our Web site at:
www.ILtax.com
- ◆ Call our 24-hour
Forms Order Line at:
1 800 356-6302

*This bulletin is written to
inform you of recent
changes; it does not replace
statutes, rules and regula-
tions, or court decisions.*

To:

All taxpayers having investments in tax shelters and all tax preparers completing tax returns on behalf of taxpayers who have investments in tax shelters.

As part of an on-going effort between many states and the Internal Revenue Service (IRS), Illinois has passed new laws (Public Act 93-840) to discourage participation in tax avoidance transactions (tax shelters). In general, the new laws mandate specific filing procedures and registration requirements for taxpayers participating in tax shelter activities, as well as the promoters of tax shelter opportunities.

In addition, the laws outline new, stringent penalties for taxpayers and promoters that do not comply with the tax shelter laws. In order to help taxpayers make the transition to the new reporting requirements, Illinois will be offering a Voluntary Compliance Program (VCP) for taxpayers that failed to report their full taxable income because they participated in tax shelter transactions.

The purpose of this bulletin is to provide general information about tax shelters, the VCP requirements, and the new associated penalties for tax shelter abuse.

What is the definition of a tax shelter?

A tax shelter is the common name for a "tax avoidance transaction." A tax avoidance transaction means any plan or arrangement devised for the principal purpose of avoiding federal income tax, and includes

but is not limited to, "listed transactions" as defined by the IRS.

What is a "listed transaction"?

A "listed transaction" is a transaction that is the same as or substantially similar to one that the IRS has determined to be a tax avoidance transaction and identified by IRS notice or other form of published guidance.

What is the Voluntary Compliance Program (VCP)?

The VCP is a program that allows taxpayers who underreported their taxable income by participating in tax shelters to come forward and pay the associated Illinois Income Tax liability without incurring any of the new penalties that have been put into effect for participating in tax shelters.

What are the dates for the VCP?

The VCP period for reporting and paying additional Illinois Income Tax liability will be from October 15, 2004, through January 31, 2005.

Who is eligible to participate?

The VCP is available to any taxpayer who

- ◆ filed an Illinois Income Tax return using a tax shelter to reduce their taxable income, or
- ◆ did not file an Illinois Income Tax return as a result of participating in a tax shelter.

What years can I amend?

Any taxable year beginning before January 1, 2004, qualifies for the VCP, if you are filing because of your involvement with tax shelter activities.

How do I participate?

In order to receive any benefit from participating in the VCP, you must

- ◆ report the correct amount of taxable income and tax liability, without regard to any tax shelters, on an Illinois amended return; and
- ◆ pay the total amount of the additional Illinois Income Tax shown on the amended return, plus any applicable interest on the amount of tax that is the result of participating in a tax shelter transaction.

In addition to these requirements, for each year that you amend, you must select one of the following options, indicating your choice of appeal rights. **Once made, this election is irrevocable.**

- ◆ **Option 1 - Voluntary Compliance without Appeal -** Under this option, you forfeit your rights to file a claim for refund of the additional tax you report on your amended return related to tax shelters. In return, the department will not impose any penalty under the Uniform Penalty and Interest Act (UPIA) for the underreporting or underpayment of the additional tax, or the new tax

shelter penalties in the Illinois Income Tax Act (IITA). You also avoid civil or criminal prosecution that may be associated with the use of tax shelter transactions for the taxable year.

- ◆ **Option 2 - Voluntary Compliance with Appeal -** You maintain your right to file a claim for refund for the taxable year that you have amended and shown an additional tax liability. In return, you avoid the new tax shelter penalties. You also avoid civil or criminal prosecution. However, you will remain subject to all other applicable penalties under the IITA and UPIA.

Note No penalty may be waived under either option 1 or 2 if the penalty relates to an amount of Illinois Income Tax assessed before October 15, 2004.

What forms must I file?

If you did not file an Illinois return because participation in a tax shelter reduced your taxable income, you will need to file an original return.

If you filed an Illinois return, and must amend in order to include income earned from participating in a tax shelter, you must file an amended return.

If you are

- ◆ an **individual** - file Form IL-1040, Individual Income Tax Return, **or** Form IL-1040-X, Amended Individual Income Tax Return;

- ◆ a **corporation** - file Form, IL-1120, Corporate Income and Replacement Tax Return, **or** Form IL-1120-X, Amended Corporation Income and Replacement Tax Return;
- ◆ an **S corporation** - file Form IL-1120-ST, Small Business Corporation Replacement Tax Return, **or** Form IL-843, Amended Return or Notice of Change in Income, and a revised Form IL-1120-ST, Small Business Corporation Replacement Tax Return;
- ◆ a **partnership** - file Form IL-1065, Partnership Replacement Tax Return, **or** Form IL-843, Amended Return or Notice of Change in Income, and a revised Form IL-1065, Partnership Replacement Tax Return;
- ◆ a **trust or an estate** - file Form IL-1041, Fiduciary Income Tax Return, **or** Form IL-843, Amended Return or Notice of Change in Income, and a revised Form IL-1041, Fiduciary Income and Replacement Tax Return.

All taxpayers must attach a VCP Participation Agreement. This form is expected to be on our Web site in the near future.

Note You must mail all Illinois original and amended returns, and the VCP Participation Agreement to the address listed on the VCP Participation Agreement. Do not send any return intended for the VCP to the mailing address listed on the Illinois original or amended return.

What are the new penalties?

- ◆ **Failure to disclose participation in a reportable transaction** - Illinois taxpayers that must disclose their participation in a reportable tax shelter to the Internal Revenue Service (IRS), are required to file a copy of that disclosure with the department. In addition, Illinois taxpayers must also disclose their participation in a transaction entered into after February 28, 2000, that becomes a "listed transaction" at any time.

Disclosure is not required if the taxpayer files an amended Illinois return that reverses the tax benefits of the reportable transaction before disclosure would otherwise be due.

Participating in the VCP will avoid the assessment of this penalty.

- ◆ **Reportable transaction understatement penalty** - This penalty applies to any deficiency of Illinois income tax that is caused by participating in any "listed transaction," or a reportable transaction if a significant purpose of the transaction is the avoidance or evasion of federal income tax. This penalty applies to tax years ending on or after December 31, 2004. This penalty may also be applied to any reportable transactions

entered into after February 28, 2000, that become "listed transactions" at any time.

Participating in the VCP will avoid the assessment of this penalty.

- ◆ **100 percent interest penalty** This penalty will be assessed if a taxpayer has been contacted by the IRS or the department regarding the use of a potential tax avoidance transaction.

Participating in the VCP will avoid the assessment of this penalty.

What are the new penalty rates?

- ◆ **Failure to disclose participation in a reportable transaction** - A penalty in the amount of \$15,000 will be assessed for each instance the taxpayer fails to disclose a reportable transaction. However, if a taxpayer fails to disclose a "listed transaction," the penalty for each instance is \$30,000.

The total of this penalty cannot exceed 10 percent of the increase in net income due to the reporting of any tax shelter activities.

- ◆ **Reportable transactions understatement penalty** - The amount of this penalty is 20 percent of the deficiency, but increases to 30 percent if the transaction was not disclosed as required.

- ◆ **100 percent interest penalty** This penalty is equal to 100 percent of the amount of interest assessed under UPIA from the payment due date through the date that a notice of deficiency is issued.

Are there any changes to how interest is assessed?

Yes. In certain situations where you have not paid your tax liability related to tax shelter activities, your interest rate may be assessed at 150 percent of the current interest rate imposed under UPIA.

Where can I get more information?

As more information regarding the VCP and general filing requirements for tax shelter activities becomes available, we will put the information on our Web site. Visit **www.ILtax.com** for updates.

You can learn more about federal reporting and registration requirements for tax shelter activities at the IRS's Web site, **www.irs.gov**.